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No. 87-1179

IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

RUSSELL T. WEIL and VIRGINIA L. WEIL,
STUART S. DYE and MARY I. DYE,
ROBERT J. HICKEY and ELEANOR L. HICKEY, and
RUSSELL T. WEIL, RONALD L. CAPONE, and
JILDA C. GARITY, as Executor, Administrator cta,
and Administratrix cta, respectively, of the Estates
of Ronald A. Capone and Margaret L. Capone,
Appellants,

v.

RODERICK G.W. CHU, FRANCIS KOENIG, and
MARK FRIEDLANDER, constituting the
State Tax Commission of the State of New York,
Appellees.

ON APPEAL FROM THE COURT OF APPEALS OF THE STATE OF NEW YORK

JURISDICTIONAL STATEMENT

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8 pp

QUESTIONS PRESENTED

1. Whether appellees violated appellants' constitutional rights by treating appellants' income from their legal practice in Washington, D.C. as New York source income under §632(a)(1) and §637(a)(1) of the N.Y. Tax Law although appellants performed no services in New York, could not practice in New York, and derived no benefit from New York.

2. Whether appellees violated appellants' constitutional rights by refusing to grant tax credits to nonresidents for income taxes paid to other jurisdictions, while granting such credits to New York residents pursuant to §620 of the N.Y. Tax Law.

3. Whether appellees acted unconstitutionally by refusing to honor a Deputy Tax Commissioner's written authorization pursuant to §637(d) of the N.Y. Tax Law concerning appellants' taxable income where appellants had complied fully with the conditions of the unrevoked authorization.

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No. ___

IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1987

RUSSELL T. WEIL and VIRGINIA L. WEIL, STUART S. DYE and MARY I. DYE, ROBERT J. HICKEY and ELEANOR L. HICKEY, and RUSSELL T. WEIL, RONALD L. CAPONE, and JILDA C. GARITY, as Executor, Administrator cta, and Administratrix cta, respectively, of the Estates of Ronald A. Capone and Margaret L. Capone, Appellants,

v.

RODERICK G.W. CHU, FRANCIS KOENIG, and MARK FRIEDLANDER, constituting the State Tax Commission of the State of New York, Appellees.

ON APPEAL FROM THE COURT OF APPEALS OF THE STATE OF NEW YORK

JURISDICTIONAL STATEMENT

The above-named appellants appeal from a final judgment of the Court of Appeals of the State of New York, dated October 15, 1987, holding that Sections 620, 632, and 637 of the Tax Law of New York, as applied

in this case, do not violate appellants' constitutional rights. This jurisdictional statement is submitted to show that this Court has jurisdiction over the appeal and that substantial constitutional questions are presented.

OPINIONS BELOW

The order of the Court of Appeals of the State of New York, which appears in the appendix hereto at page 1a, is reported at 70 N.Y.2d 783. The order and memorandum decision of the lower court (the Appellate Division of the Supreme Court of the State of New York) are reported at 120 A.D.2d 781, and appear in the appendix hereto at pages 3a and 5a. The subject decision of the State Tax Commission of the State of New York, dated July 9, 1984, is unreported, but appears in the appendix hereto at page 12a.

JURISDICTION

The order of the New York Court of Appeals affirmed the lower court decision

upholding the constitutionality of the Tax Law of New York as applied to appellants by appellees, the State Tax Commission of New York. The order of the New York Court of Appeals was entered on October 15, 1987, and appellants' notice of appeal to this Court was duly filed in the New York Court of Appeals on November 13, 1987. See appendix hereto, pages 1a and 29a.

This appeal is being docketed in this Court within 90 days of entry of the order of the New York Court of Appeals. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. §1257(2).

CONSTITUTIONAL PROVISIONS AND STATUTES INVOLVED

Article I, Section 8, United States Constitution:

> The Congress shall have Power... To regulate Commerce with foreign Nations, and among the several States....

Article I, Section 10, United States Constitution:

> No State shall... pass any... Law impairing the Obligation of Contracts....

Article IV, Section 2, United States Constitution:

> The Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States.

Fourteenth Amendment, Section 1, United States Constitution:

> No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.

Section 601(b) of the Tax Law of New York:

> A partnership as such shall not be subject to tax under this article. Persons carrying on business as partners shall be liable for tax under this article only in their separate or individual capacities.

Section 620(a) of the Tax Law of New York:

> A resident shall be allowed a credit against the tax otherwise due under this article for any income tax imposed for the taxable year by

another state of the United States, a political subdivision of such state or by the District of Columbia, upon income both derived therefrom and subject to tax under this article.

Section 632(a) of the Tax Law of New York:

The New York adjusted gross income of a nonresident individual shall be the sum of the following:

(1) The net amount of items of income, gain, loss and deduction entering into his federal adjusted gross income, as defined in the laws of the United States for the taxable year, derived from or connected with New York sources, including:

(A) his distributive share of partnership income, gain, loss and deduction, determined under section six hundred thirty-seven....

Section 632(b)(1) of the Tax Law of New York:

Items of income, gain, loss and deduction derived from or connected with New York sources shall be those items attributable to:

...(B) a business, trade, profession or occupation carried on in this state.

Section 637 of the Tax Law of New York:

(a) Portion derived from New York sources.

(1) In determining New York adjusted gross income of a nonresident partner

> of any partnership, there shall be included only the portion derived from or connected with New York sources of such partner's distributive share of items of partnership income, gain, loss and deduction entering into his federal adjusted gross income, as such portion shall be determined under regulations of the tax commission consistent with the applicable rules of section six hundred thirty-two.
>
> * * *
>
> (d) Alternate methods. The tax commission may, on application, authorize the use of such other methods of determining a nonresident partner's portion of partnership items derived from or connected with New York sources, and the modifications related thereto, as may be appropriate and equitable, on such terms and conditions as it may require.

HOW THE FEDERAL QUESTIONS WERE RAISED

At the earliest stage of the administrative proceedings below appellants raised their claims that the Tax Law of New York, as applied to appellants, violates United States constitutional guarantees. See appendix hereto at page 14a. Appellees, constituting the State Tax Commission of New York, declined to consider appellants'

constitutional claims, insisting that constitutionality would be "presumed." Id. at 25a.

On review before the Appellate Division of the Supreme Court of the State of New York (the court of first instance) appellants again asserted their constitutional claims, all of which were expressly rejected by that court. See appendix hereto at pages 7a-10a. Finally, appellants reiterated their constitutional claims before the New York Court of Appeals, but that court affirmed the judgment below in toto without issuing a further opinion. Id. at 1a.

STATEMENT OF THE CASE

This case involves appellees' assertion that appellants are required to pay New York City and State personal income taxes pursuant to the Tax Law of New York. The undisputed facts of record, for the most

part expressly adopted by appellees (see pages 15a-25a, infra), are as follows:

Appellants Ronald A. Capone, Russell T. Weil, Robert J. Hickey, and Stuart S. Dye (hereinafter "appellants") practiced law during the subject tax years (1976-79) in Washington, D.C. [1] Appellants were affiliated with a law firm known as Kirlin, Campbell & Keating ("the firm"), a partnership engaged in the full-time practice of law with offices in Washington, D.C. and New York City.

Appellant Capone was a resident of Virginia and filed income tax returns with that state. Similarly, appellants Weil, Hickey, and Dye were residents of Maryland and filed tax returns in Maryland. All

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[1] The spouses of these attorneys are also appellants, but are not discussed specifically hereafter. Ronald A. Capone and his spouse are now deceased; their executor, administrator cta, and administratrix cta were substituted in the court below as appellants herein.

appellants practiced law only in Washington, D.C., and were never admitted to practice law in New York.

None of the appellants maintained an office or work space in the firm's New York office, or even had a key to that office. The status of each appellant was clearly designated and limited to Washington, D.C. on the firm's letterheads and in the firm's listings in Martindale-Hubbell Law Directory. Virtually all matters handled by appellants were generated in the Washington office of the firm.

Data on Washington client matters, including work files, retainer agreements, billable hours, and disbursements were always kept in the Washington office. Fees generated by the Washington office normally were directly billed, collected, and deposited in a Washington, D.C. bank account, separate and distinct from accounts kept in New York.

Records of gross receipts and expenses were always maintained on a separate basis for the firm's two offices. The fees and disbursements collected by the Washington office were more than sufficient to cover all expenses of that office, including rent, salaries, other overhead, and the Washington partners' incomes.

In November 1971, the Audit Division of the New York Tax Department initiated an investigation during which New York income tax deficiencies were asserted in regard to appellant Capone for tax years 1967 and 1968. On October 12, 1972, appellants Capone and Weil attended a conference in Albany, New York, chaired by Deputy Tax Commissioner Donovan, who was accompanied by numerous officials of the Law and Income Tax Bureaus of the Tax Department. At that conference, appellants Capone and Weil stated all the pertinent facts concerning the firm's Washington office and lawyers,

the partnership agreement, clients, fees, expenses, and the net surplus flowing from Washington to the firm's New York partners. The appellants attending the October 1972 conference urged that the Washington partners should not be subject to New York taxes because New York was not the source of their incomes, that the method of the firm for determining New York tax liability was appropriate and equitable, and that this method should be authorized pursuant to §637(d) of the Tax Law of New York. It was also stated that an adverse determination would require a change in the relationship between the firm's Washington and New York offices in order to avoid New York taxation of income produced in Washington.

At Deputy Commissioner Donovan's request, appellants in early November 1972 also submitted legal memoranda to Mr. Donovan. The memoranda expressly sought approval of appellants' §637(d) alternate method for

determining New York tax liability. That method, which appellants have continued to use in subsequent years, was described in the memoranda as follows:

> As long as the net profit of the Washington Office is equal to, or exceeds the remuneration received in a particular year, all of his partnership income is properly allocable to Washington rather than to New York.... If and when his remuneration is greater than the net profit of the Washington office in any year, the excess should be treated as income from New York sources....

On November 13, 1972, Mr. Donovan, on behalf of appellees, advised appellant Capone that there would be no New York tax liability for the years 1967-71. As to future years, Mr. Donovan further advised that he would consider imposing taxes <u>if</u> New York State were to lose revenue because untaxed New York income was supplementing the Washington partners' incomes. On November 22, 1972, Mr. Donovan transmitted a written authorization stating in respect to future years:

> For subsequent years, I must reserve the right to require a change in the method of reporting partnership income on the individual nonresident returns for any year in which the State of New York would suffer a loss in tax revenue. [2]

Relying on Deputy Commissioner Donovan's §637(d) authorization on behalf of appellees, appellants did not sever their relations with the firm or attempt to change the firm structure. In every respect, appellants settled their accounts with the firm and otherwise planned their personal finances in reliance on appellees' written authorization. And the conditions for the method approved by Mr. Donovan were satisfied during each of the tax years in question, i.e., there continued to be a

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[2] It should be noted that even if there were a net loss in future years, this would not automatically result in the authorization being revoked, but would only trigger a review for future years.

substantial net flow of income from the Washington office to the New York partners. [3]

On March 1, 1978, six years after the Donovan authorization, letters were written by the Audit Division of the Tax Department requesting appellants to file New York income tax returns for 1974. By letter dated April 20, 1978, the Audit Division acknowledged that the activities of the firm essentially had not changed since 1972, and that appellants had relied on Mr. Donovan's written authorization. However, despite repeated requests for relief the Director of the Audit Division on March 23, 1980 summarily rejected the Donovan authorization

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[3] As a result, not only was there no loss of tax revenue to New York State, there was a gain because appellants' resident New York partners paid added taxes as a result of the Washington source income they received.

and directed that tax deficiencies be asserted against appellants. [4]

On July 9, 1984, more than four years after appellants duly filed petitions for redetermination, appellees, constituting the State Tax Commission of New York, issued their administrative decision. Appellees denied appellants' petitions in toto following less than three pages of legal analysis. See pages 25a-28a, infra. On November 3, 1984 appellants duly filed petitions for court review, seeking an order vacating and setting aside appellees' decision as unconstitutional and unlawful. On May 1, 1986 the Appellate Division of the New York Supreme Court issued a memorandum decision upholding appellees' decision, and an order to that effect was entered on May 5, 1986.

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[4] The years in question were generally 1976-79, although this varies by appellant. The issues raised in this appeal have also been raised with regard to all years subsequent to 1979.

See pages 3a and 5a, infra. Thereafter, appellants appealed to the New York Court of Appeals. Following briefing and oral argument, on October 15, 1987 that court summarily affirmed the judgment of the lower court, without further opinion. See page 1a, infra.

THE QUESTIONS ARE SUBSTANTIAL

I. The Presented Issues Are Constitutionally-Important And Of National Significance

This case raises significant and important constitutional questions that this Court has not previously considered. These questions should be decided by the Court following full briefing and oral argument.

Specifically, this Court is asked to determine whether New York State may constitutionally tax the personal service income of nonresident professionals who do not work in New York, are not authorized to practice in New York, and who have no

income-producing activities in New York. This issue is of critical importance with respect to the application of state tax laws to nonresidents and nonresident partners of multi-state firms. This issue has broad and immediate impact on the ability of multi-state firms to establish and maintain out-of-state offices, which benefit the public at large.

In an era of ever-increasing multi-state professional firms and partnerships, this is a matter of national importance, not merely affecting appellants. For example, in the District of Columbia alone approximately 3,500 lawyers are affiliated with 245 law firms having their principal offices in other states, and those firms have approximately 700 offices in 177 cities in 44 states. The Legal Times, June 30, 1986. The problem of multi-state taxation affects practioners in small firms, who often

desire to do business in other states,[5] as well as partners of large firms.

So too, the ability of states to tax nonresidents having no substantial contact with those states is an important issue from the perspective of avoiding unwarranted restrictions on nonresident professionals, and the inevitable threat of retaliation by other states when such restrictions are imposed.

Appellants' case also challenges the constitutionality of appellees' denial of tax credits to nonresidents for income taxes paid to other jurisdictions, while granting such credits to residents. This is a matter of significant public importance, directly affecting hundreds of thousands of nonresident taxpayers. For example, in New York alone 341,677 nonresidents were required to

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[5] See Frazier v. Heebe, __ U.S. __, 107 S.Ct. 2607 (1987); Supreme Court of New Hampshire v. Piper, 470 U.S. 274 (1985).

pay $623 million in state income taxes in 1983. [6] The denial of tax credits is all the more important since the decision of the New York Court of Appeals affirming appellees' position is in direct constitutional conflict with decisions of this Court.

Appellants' final challenge involves the failure of the State of New York to abide by its agreements after appellants had observed, to their detriment, the conditions of the commitment. Since all state governments enter into hundreds, if not thousands, of agreements daily, a decision permitting appellees to renege without justification would have profound and substantial impact.

II. Appellees' Treatment Of Appellants' Incomes As New York Source Income Is Unconstitutional

The record establishes, inter alia, that: (1) appellants were not residents of New

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[6] Publication 410, N.Y. Dept. of Taxation & Finance, Bureau of Trade Statistics.

York; (2) they had no income producing activities in New York; (3) they neither worked nor had any offices in New York; (4) no benefits were conferred on them by New York; (5) fees they earned from their legal practice in Washington more than covered all their income and office expenses; and (6) during the subject tax years there was a substantial net flow of income from appellants' Washington practice to their partners in New York.

Since New York has no jurisdiction over a nonresident's non-New York income, the tax imposed on appellants violates their due process rights, impermissibly infringes on the commerce clause, violates equal protection guarantees, and discriminates against appellants in contravention of the privileges and immunities clauses.

A. Violation of Due Process

"Due process" under the Fourteenth Amendment requires fundamental fairness to

individuals who may reasonably expect that they will not be taxed by a state with which they have only the most tenuous contact. In this case, New York's tax on appellants' individual incomes constitutes a denial of due process. A substantial connection with New York is absent, since, e.g., appellants' practice of law was entirely outside of New York, they essentially served non-New York clients, no integration of activity existed between the Washington and New York offices, and New York provided no benefits or services to appellants that would justify taxation of their personal incomes. See, e.g., Asarco, Inc. v. Idaho STC, 458 U.S. 307 (1982); Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979); Connecticut General Life Insurance Co. v. Johnson, 303 U.S. 77 (1938); Hans Rees' Sons v. North Carolina ex rel. Maxwell, 283 U.S. 123 (1931).

The due process clause bars a state's "effort to reach profits earned elsewhere under the guise of legitimate taxation." Asarco, Inc. v. Idaho STC, supra at 328. Further, even a tax that can be legitimately imposed cannot be "out of all appropriate proportion to the business transacted by the taxpayer in the State." Hans Rees' Sons, supra at 135. No nexus, let alone a substantial nexus, exists between appellants' income-producing activities (i.e., their law practice) and the State of New York. While appellants were affiliated with a law firm having offices in New York, their professional activities were conducted in Washington, not New York. There was also no integration, functional, managerial, or horizontal, of activities between the firm's New York and Washington offices. [7] See

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[7] For instance, appellants had a different client base and performed different legal services than their New York partners; they were not licensed [cont'd.]

Mobil Oil Corp. v. Commissioner, 445 U.S. 437, 448 (1980). Furthermore, New York State conferred no benefits or services on appellants. In sum, appellees' tax is not based on a substantial relationship and is not fairly proportioned to business in New York, thus violating appellants' due process rights. [8]

B. Interstate Commerce Infringement

The tax on appellants' incomes also violates the "commerce clause," Article I, §8, Clause 3. In Complete Auto Transit v. Brady, 430 U.S. 274 (1977), this Court declared that state taxation is permissible only if four requirements are met: (1) the taxpayer must have a substantial nexus with

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[footnote cont'd.] to practice in New York and did not have office space in New York; and the administration of each office was kept separate as to management and supplies.

[8] Clearly, New York's allocation formula, which allocates 74 to 80% of appellants' incomes to New York, is grossly unfair considering that appellants' incomes are 100% earned in Washington.

the taxing state; (2) the tax must be fairly apportioned; (3) the tax cannot discriminate against interstate commerce; and (4) the tax must fairly relate to services actually provided by the taxing state. None of these requirements is met in the present case.

First, in order for a "substantial nexus" to exist, there must be a "definite link" between the taxing state and the taxpayer. National Bellas Hess, Inc. v. Department of Revenue, 386 U.S. 753, 756 (1967); Miller Brothers Co. v. Maryland, 347 U.S. 340, 344-45 (1954). In this case, there is no substantial nexus between New York State and appellants' practice of law in Washington. Compare Tyler Pipe Industries, Inc. v. Washington Department of Revenue, __ U.S. __, 107 S.Ct. 2810, 2822 (1987). The mere fact that other partners of appellants' firm practice law in New York "bears no relation to where [appellants'] services are actually rendered," Sea-Land Service, Inc. v. San

Juan, 505 F. Supp. 533, 553 (D.P.R. 1980), citing Exxon Corp. v. Wisconsin Department of Revenue, 447 U.S. 207 (1980), and does not provide a substantial nexus to appellants' legal practice in Washington.[9]

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[9] The assessment involved in this case is against the individual appellants who perform their services in Washington, not their firm. However, New York State improperly focuses on the "income" of the partnership as an alleged entity engaged in taxed activity, not on the income of the nonresident individuals. However, §632(b)(1)(B) of the New York Tax Law specifically states: "Items of income...derived from or connected with New York sources shall be those items attributable to...[a] profession or occupation carried on in this state." Section 601(b) of the Tax Law specifically provides that "A partnership as such shall not be subject to tax.... Persons carrying on business as partners shall be liable for tax...only in their separate or individual capacities." Title 20 of the New York Code of Rules and Regulations, §131.4, also provides that an individual is carrying on a business or profession in New York only if he has an office or work place for his business "where his affairs are systematically and regularly carried on," and only if he engages in his business "with a fair measure of permanence and continuity."

Moreover, no correlation exists between the money received by the firm and appellants' partnership points. The firm's Washington office has subsidized [cont'd.]

Second, a tax on interstate commerce must be "reasonably apportioned to the value of the activities occurring within the state upon which the tax is imposed." Maryland v. Louisiana, 451 U. S. 725, 754-55 n.27 (1981) [emphasis added]; accord, Nippert v. Richmond, 327 U.S. 416, 427 (1946). Since the value of the Washington activity that produced appellants' income has no connection with New York, a fair apportionment would result in no New York taxation.

Third, the proposed tax would place a discriminatory burden on appellants, viz., a "burden of such a nature as to be capable... of being imposed... with equal right by every state which the commerce touches, merely because interstate commerce is being done, so that without the protection of the

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[footnote cont'd.] the New York office and the New York partners. Further, partnership shares were used as a starting point to determine appellants' distribution, not either as the final or controlling determination.

commerce clause it would bear cumulative burdens not imposed on local commerce." Western Live Stock v. Bureau of Revenue, 303 U.S. 250, 255-56 (1938). The New York tax would clearly produce such cumulative burdens since appellants are taxed both by New York on income produced solely in Washington, and at the same time by their local jurisdictions. [10] Consequently, the tax would discriminate against appellants' ability to practice law in Washington and affiliate with lawyers practicing in New York State. Such discrimination unduly burdens interstate professional contacts and serves no legitimate local purpose. See, e.g., Sporhase v. Nebraska ex rel Douglas, 458 U.S. 941, 957 (1982); Hunt v. Washington

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[10] Appellants residing in Maryland cannot obtain any tax credit that would excuse them from paying substantial income taxes to local jurisdictions in Maryland, in addition to any New York income taxes. See Ann. Code of Md., Art. 81, §290(b).

State Apple Advertising Commission, 432 U.S. 333, 353 (1977).

Finally, no fair or reasonable relationship exists between the tax and any services actually provided to appellants by New York. Appellants receive from Washington, D.C., Maryland or Virginia their schools, police, fire and health protection, streets, roads, sewer facilities and all other valuable state and municipal services. Individual appellants receive no services whatever from the City or State of New York. The New York tax does not inure to the benefit of appellants in the form of any tangible or intangible benefits or services rendered by New York. In these circumstances, the tax is unconstitutional under the commerce clause. See American Truckers Association v. Scheiner, __ U.S. __, 107 S.Ct. 2829, 2844 (1987); Ingels v. Morf, 300 U.S. 290, 294 (1937).

C. Violation of Equal Protection

Appellants' incomes from their legal practice in Washington are being taxed solely because they were partners of the firm. However, the incomes of others (i.e., employees) working for the firm in Washington were not taxed; neither were the earnings of attorneys unaffiliated with a New York firm who practice and reside in the Washington area, even though they (unlike appellants) may have very extensive business dealings in New York. This disparate treatment of nonresident individuals is arbitrary and invidious, evidences no rational basis or legitimate purpose, and lacks any showing that an otherwise non-discriminatory means was unavailable. Thus, the taxation of appellants' incomes also violates "equal protection" guarantees of the Fourteenth Amendment. See, e.g., Williams v. Vermont, 472 U.S. 14, 23-24

(1985); WHYY v. Glassboro, 393 U.S. 117, 119 (1968). [11]

D. Denial of Privileges And Immunities

States are prohibited by Article IV, §2 and the Fourteenth Amendment from granting privileges or immunities except to all persons. Under these clauses, one state cannot discriminate against citizens of another state. Slaughter House Cases, 16 Wall (U.S.) 36, 77 (1873). The interest at

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[11] Congress, in enacting the Fourteenth Amendment, clearly was aiming to provide, inter alia, an overriding federal equal taxation law. In the Voting Rights Act of 1870, 16 Stat. 140, 144, Section 16 provides: "all persons within the jurisdiction of the United States... shall be subject to like... taxes and none under any law, ... to the contrary not withstanding." The Voting Rights Act of 1870, codified and combined with the Civil Rights Act of 1866, as found in 42 U.S.C. §1981, was merely meant to be a legislative provision enforcing the Fourteenth and Fifteenth Amendments. Despite the amalgam of the statutes, there is no indication that Congress in any way intended to restrict the equal taxation provisions. This concept is defeated by the New York tax where a disproportionate tax is ultimately borne through multi-state taxation of nonresident appellants.

stake in this case, the pursuit of one's livelihood, including the pursuit of an occupation outside an individual's home state free from economic discrimination, is clearly protected by these clauses. Compare Hicklin v. Orbeck, 437 U.S. 518 (1978).

The standard of review requires more than mere "rationality" to sustain taxation of nonresidents. See Austin v. New Hampshire, 420 U.S. 656, 662-3 (1975). A state may impose burdens on nonresidents, but only on the basis that they receive specific state benefits. Even then, the imposed burden must be distributed to nonresidents reasonably and fairly, such that the tax is aligned either with any additional expenses specifically caused by the nonresidents or the reasonable costs of benefits actually provided by the state. Compare Mullaney v. Anderson, 342 U.S. 415 (1952); Travelers' Insurance Co. v. Connecticut, 185 U.S. 364, 368-9 (1902). In this case, appellants

received no benefits from New York and imposed no costs on that state. It is apparent that the real and sole purpose of New York's tax on appellants is to increase the state's revenue by taxing non-New York income, which the privileges and immunities clauses prohibit. Compare Austin v. New Hampshire, supra at 666.

III. Appellees' Denial Of Tax Credits To Nonresident Appellants Is Unconstitutional

The second issue before this Court involves the constitutionality of New York's refusal to grant credits to the individual nonresident appellants for income taxes paid to other jurisdictions, while granting such credits to New York residents. [12] Appellees

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[12] How this works can be seen in the following example. Both "A," a resident of New York, and "B," a resident of Montgomery County, Maryland, pay the following taxes: New York--$40,000, Maryland--$20,000, and Montgomery County--$10,000. A receives, but B does not, a credit for $30,000 from New York. Further, because Maryland allows only a partial offset and Montgomery County no offset, B is forced to pay a [cont'd.]

base their refusal on the provisions of the Tax Law of New York, which does not expressly address credits for nonresidents, while Tax Law §620 states that residents shall receive a credit. Whenever a resident and nonresident have the same New York taxable income, subject to both New York and out-of-state taxes, under appellees' scenario the nonresident must pay higher taxes to New York than the resident as a result of the credit granted only to residents. [13] This is so despite the fact that nonresidents receive their basic governmental services elsewhere.

[footnote cont'd.] double tax. In addition, because B's income was earned in Washington but he pays the higher New York tax rate on most of his income, he is effectively taxed at a higher rate than other Maryland attorney residents.

[13] The effect of the tax credit is that New York subsidizes its residents by paying out-of-state taxes for them (through the credit) but grants no subsidy to nonresidents, who are thus subjected to double taxation.

A. Violation Of The Privileges And Immunities Clauses

The constitutional issue before this Court is not whether New York may grant a credit to its residents for taxes paid to other states. Rather, it is whether a comparable credit may be simultaneously denied to nonresidents solely because they are nonresidents. Such discriminatory tax treatment clearly violates the privileges and immunities clauses of Article IV, §2, and the Fourteenth Amendment. Travis v. Yale & Towne Manufacturing Co., 252 U.S. 60, 78-81 (1919) (holding unconstitutional tax exemptions granted to New York residents, but not to nonresidents). In Austin v. New Hampshire, 420 U.S. 656, 662-668 (1975), this Court, after noting that the judiciary must exercise "heightened concern for the integrity of the Privileges and Immunities Clause by erecting a standard of review substantially more rigorous" in regard to

discriminatory tax treatment of nonresidents, condemned state tax treatment "operating to the disadvantage of all nonresidents... and favoring all residents" as plainly unconstitutional under the privileges and immunities clauses. Accord, Hicklin v. Orbeck, supra. Whether the inequality of tax treatment between residents and nonresidents relates to tax rates, exemptions, or credits, as in this appeal, such inequality plainly violates the privileges and immunities clauses.

B. Violation Of Equal Protection

The equal protection clause precludes discriminatory tax treatment solely on the basis of residence versus nonresidence. WHYY v. Glassboro, supra; Wheeling Steel Corp. v. Glander, 337 U.S. 562, 571-72 (1949). In Williams v. Vermont, supra at 23-26, this Court reaffirmed this basic principle in striking down a Vermont

statute that afforded tax credits to residents, but denied comparable credits to nonresidents solely because of their nonresidency. In the instant appeal, there was no finding by appellees that appellants caused special problems or received special benefits, let alone that the discrimination imposed on them was reasonably and legitimately related to those facts. Thus, to deny them a tax credit, while granting one to residents, is clearly unconstitutional.

C. Undue Burden On Interstate Commerce

This Court has also condemned discriminatory tax treatment based on residency or locality, such as in this case, as violative of the commerce clause, Article I, §8, Clause 3. In Westinghouse Electric Corp. v. Tully, 466 U.S. 388 (1984), a New York tax credit granted to local businesses, but denied to out-of-state businesses, was found to impose an unconstitutional burden

on interstate commerce. A similar conclusion was reached by this Court in Halliburton Oil Well Co. v. Reily, 373 U.S. 64, 70 (1963), emphasizing that taxpayers must be treated equally and that discrimination cannot be based on a taxpayer's location. Compare Tyler Pipe Industries, Inc. v. Washington, supra at 2823; American Truckers Association v. Scheiner, supra.

D. Relation to Home-State Tax Law

New York State has theorized that appellants could lessen the impact of the discrimination against them by appealing for relief, such as compensating credits, from their home states. However, this Court has repeatedly rejected this self-help suggestion as a cure for unconstitutionality. See, e.g., Austin v. New Hampshire, supra at 666-67 (1975); Wheeling Steel Corp. v. Glander, 337 U.S. 562 (1949); Travis v. Yale & Towne Manufacturing Co., supra; see also

Tyler Pipe Industries, Inc. v. Washington, supra at 2817.

Appellees also cannot urge that the credit is legitimately designed to avoid "double taxation of income" for New York residents only. It is unconstitutional to afford residents relief from double taxation while denying appellants relief from the very same problem. "The fact that it may be rational or beneficent to spare some the burden of double taxation does not mean that the beneficence can be distributed arbitrarily." Williams v. Vermont, supra at 27 (1985) [emphasis added]. Otherwise, a New York resident, who receives all the services and protections afforded by New York, would pay lower taxes than a nonresident on the same amount of taxable income, even though such nonresident, by virtue of his non-residency, receives none of the services and protections afforded by New York.

IV. Appellees' Refusal To Honor Their §637(d) Authorized Agreement Is Unconstitutional

New York Tax Law §637(d), governing nonresident partners, provides that the appellees:

> may, on application, authorize the use of such other methods of determining a nonresident partner's portion of partnership items derived from or connection with New York sources, and the modifications related thereto, as may be appropriate and equitable, on such terms and conditions as it may require.

Deputy Tax Commissioner Donovan,[14] in an institutional decision reached after a series of meetings and telephone conversations in which numerous persons from the New

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[14] It should be noted that appellees have never challenged the authority of Deputy Commissioner Donovan to enter into a §637(d) authorization on their behalf, nor have they identified any defect in their authorization that resulted from the §637(d) process. Neither is there anything in the Tax Law or regulations which would indicate that the Deputy Tax Commissioner could not approve an alternate method on behalf of appellees. To the knowledge of appellants, appellees never have contended that the Tax Commission did not so approve the Donovan agreement.

York Tax Bureau participated, entered into an agreement granting appellants' request for an alternate method of allocation, and authorizing appellants' positive net flow method of apportioning partnership income. The only condition imposed was that:

> For subsequent years, I must reserve the right to require a change in the method of reporting partnership income on the individual nonresident returns for any year in which the State of New York would suffer a loss in tax revenue [emphasis added].

The wording of this §637(d) authorization makes clear that appellees approved a prospective method for tax accounting which would be honored as long as appellants provided a positive net flow of income to New York. Appellees reserved the right to review the situation if and when there was a negative income flow from New York to Washington. The condition did not state that a negative flow would, by itself, result in disapproval of future use of appellants' method, but solely that a review

would occur. At no time did a negative flow occur or did Mr. Donovan, his successors, or anyone of a similar or higher status, actually revoke the agreement, and appellees do not contend otherwise. [15]

Indeed, it is undisputed that during the subject tax years, 1976-79, (and to date) the only condition of appellees' authorization was met, with a substantial net flow of income from appellants' Washington office to the firm's New York partners. [16]

Appellants structured their firm so that this positive net flow would be produced in order to meet appellees' condition. This reliance on appellees' authorization has

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[15] Even if a negative income flow had occurred, appellees still might have allowed appellants' authorized method to continue because of overall benefit to the state over a number of years even though, in a given year, there might be a negative flow.

[16] Appellees, although concluding as a matter of law that any loss of income to the state was "irrelevant," conceded that the positive flow was more than sufficient. See pp. 26a, 19a, infra.

been seriously detrimental to appellants: if they had severed their relationship with the New York partners their entire Washington-office revenue would have stayed in Washington, thereby increasing their incomes. In contrast, New York has benefited because the added income flowing to the New York resident partners of the firm under the agreement has produced additional taxable state income.

In circumstances such as this, governmental entities must abide by their agreements. In Perry v. United States, 294 U.S. 330, 351-52 (1935), this Court stated:

> When the United States, with constitutional authority, makes contracts, it has rights and incurs responsibilities similarly to those of individuals who are parties to such instruments.
>
> * * *
>
> To say that the Congress may withdraw or ignore that pledge is to assume the Constitution contemplates a vain promise; a pledge having no other sanction than the pleasure and the convenience of the pledgor. This Court has given no sanction to such a

> conception of the obligation of our government.

Thus, government agreements are binding so long as the imposed conditions are met, and appellees' failure to honor their authorization herein is a breach of the state's agreement. Constitutional due process and appellees' contractual commitment do not permit such a breach. Allgeyer v. Louisiana, 165 U.S. 578, 589 (1897). [17]

In sum, appellees' failure to honor their commitment renders New York Tax Law §637(d) a nullity. This failure is particularly

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[17] The decision of the New York Court of Appeals herein, to the extent that it denies a remedy for breach of contract, constitutes a denial of due process under the Fourteenth Amendment. Compare Central Georgia Railroad Co. v. Wright, 207 U.S. 127 (1907); Pullman Co. v. Knot, 235 U.S. 23 (1914). Appellees' refusal to abide by their authorization is subject also to the constitutional restrictions imposed by Article I, Section 10. State Bank of Ohio v. Knoop, 57 U.S. 369 (1854); Great Southern Hotel Co. v. Jones, 193 U.S. 532, 548 (1904). In State Bank of Ohio v. Knoop, the Court held that a contract within the meaning of Article I, Section 10, could not be repudiated by the state.

egregious where there has never been a revocation, where there could be no revocation because there has been no negative income flow, and where there has been no intervening statutory change in §637(d). The failure of appellees to honor their authorized agreement after appellants complied with its terms plainly constitutes a denial of due process and a breach of appellees' obligations to appellants.

CONCLUSION

For all the foregoing reasons, this Court has jurisdiction in this case, which presents important and substantial questions requiring the Court's plenary review.

Respectfully submitted,

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James W. Pewett
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Counsel for Appellants

January 13, 1988

APPENDIX

APPENDIX A

COURT OF APPEALS
STATE OF NEW YORK

The Hon. Sol Wachtler, Chief Judge, Presiding

No. 242

In the Matter of Russell T. Weil, et al.,

Appellants,

v.

Roderick G. W. Chu, et al.,

Respondents.

The appellant(s) in the above entitled appeal appeared by Ernesto V. Luzzatto, Esq.;

the respondent(s) appeared by Hon. Robert Abrams, Attorney General of the State of New York.

The Court, after due deliberation, orders and adjudges that the judgment is affirmed, with costs, for the reasons stated in the memorandum at the Appellate Division (120 AD2d 781). Chief Judge Wachtler and Judges Simons, Kaye, Alexander, Titone, Hancock and Bellacosa concur.

The Court further orders that the papers required to be filed and this record of the proceedings in this Court be remitted to the Supreme Court, Albany County

there to be proceeded upon according to law.

I certify that the preceding contains a correct record of the proceedings in this appeal in the Court of Appeals and that the papers required to be filed are attached.

/s/Donald M. Sheraw
Donald M. Sheraw, Clerk of the Court

Court of Appeals, Clerk's Office, Albany, October 15, 1987.

APPENDIX B

At a Term of the Appellate Division of the Supreme Court of the State of New York, held in and for the Third Judicial Department, at the Justice Building, in the City of Albany, New York, commencing on the 10th day of March, 1986.

PRESENT: HON. ROBERT G. MAIN,
Justice Presiding.
HON. JOHN T. CASEY,
HON. ANN T. MIKOLL,
HON. PAUL J. YESAWICH, JR.,
HON. NORMAN L. HARVEY,
Associate Justices.

In the Matter of RUSSELL T. WEIL and VIRGINIA L. WEIL, STUART S. DYE and MARY I. DYE, ROBERT J. HICKEY and ELEANOR L. HICKEY, and RONALD A. CAPONE and MARGARET L. CAPONE,

Petitioners,

For a Judgment Under Article 78, Civil Practice Law and Rules to Annul Decision of State Tax Commission and to Vacate and Set Aside Personal Income Tax Deficiencies,

-against-

RODERICK G.W. CHU, FRANCIS KOENIG and MARK FRIEDLANDER, constituting the State Tax Commission of the State of New York,

Respondents.

ORDER
51160

The above-named petitioners having instituted this proceeding in Supreme Court, Albany County, pursuant to

Article 78 of the Civil Practice Law and Rules, to review a determination of the State Tax Commission which sustained personal income tax assessments imposed under Tax Law article 22, and said proceeding having been transferred for disposition to the Appellate Division, Third Department, by order of the Supreme Court at Special Term, dated January 11, 1985 and entered in Albany County, and having been presented during the above-stated Term of this Court and having been argued by Russell T. Weil, Esq., *pro hac vice,* Ernesto V. Luzzato, Esq., of counsel for petitioners, and by Francis V. Dow, Assistant Attorney General, of counsel for respondents and after due deliberation, the Court having rendered a decision on the 1st day of May, 1986, it is hereby

ORDERED, that the determination be, and the same hereby is confirmed, and the petition is dismissed, without costs.

E N T E R:

/s/ Michael J. Novack
Clerk

DATED AND ENTERED: May 5, 1986.
A TRUE COPY
/s/Michael J. Novack
CLERK

APPENDIX C

Supreme Court—Appellate Division
Third Judicial Department

May 1, 1986 51160

In the Matter of RUSSELL T. WEIL et al.,
Petitioners,

v.

RODERICK G. W. CHU et al., Constituting the State Tax Commission of the State of New York,
Respondents.

MIKOLL, J.

Proceeding pursuant to CPLR article 78 (transferred to this court by order of the Supreme Court at Special Term, entered in Albany County) to review a determination of the State Tax Commission which sustained personal income tax assessments imposed under Tax Law article 22.

Petitioners* Russell T. Weil, Stuart S. Dye, Robert J. Hickey and Ronald A. Capone are attorneys in the Washington, D.C., office of the law firm of Kirlin, Campbell & Keating (hereinafter the law firm), which also has an office in New York City. Petitioners commenced this CPLR article 78 proceeding to review a determination of the State Tax Commission which sustained several notices of deficiency issued to petitioners for New York State personal income taxes and New York City nonresident earnings taxes for the years 1976 through 1979. The deficiencies were issued on the basis that a portion of petitioners' distributive shares of partnership income from the law firm were derived from or connected with New York State and were therefore taxable.

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* The spouses of these petitioners are also named as petitioners but, since they are not otherwise relevant to this proceeding, they will not be referred to again.

Several years prior to issuing the notices of deficiency which are at issue in the instant case, the Tax Commission had considered the tax liability of the partners at the law firm's Washington office. After a conference held regarding deficiencies asserted in 1971 against Capone, then-Deputy Commissioner John Donovan advised Capone that he was not liable for taxes for the years 1967 through 1971. The apparent basis for this decision was the fact that the income of the law firm's Washington office exceeded the costs of operating the office and Capone's share of partnership income, resulting in a net flow of income into the New York office of the partnership and, therefore, tax revenue to New York State. Petitioners contended that the method used by them for reporting partnership income had been approved by Donovan in 1972, but the Audit Division of the Department of Taxation and Finance rejected this argument and issued the notices of deficiency.

A hearing was held in 1981 after petitioners filed petitions for redetermination of the notices of deficiency. In 1984, the Tax Commission rendered a decision holding that petitioners were taxable upon the portion of their distributive share of partnership income which was attributable to the partnership's activities in New York pursuant to Tax Law § 637 (a) (1). The Tax Commission also ruled that petitioners were not entitled to use an alternative method for allocating that portion attributable to New York. Petitioners thereafter commenced separate CPLR article 78 proceedings to vacate and set aside the Tax Commission's decision. Special Term consolidated the proceedings into the instant proceeding and transferred it to this court.

The determination of the Tax Commission should be confirmed. Petitioners have failed to meet their burden of showing that the Tax Commission's method of allocating New York source income was improper or that petitioners' method was more appropriate or equitable. The application

of New York State income taxes to petitioners is not unconstitutional.

Petitioners' contention that none of their income was derived from or connected with New York and that, therefore, they are not liable for New York State income tax pursuant to Tax Law § 601 (b), § 632 (a) (1) and § 637 is not persuasive. Petitioners' assert that they have never practiced law or been authorized to practice law in New York, that they have practiced law exclusively in Washington and that almost all of their clients and fees were generated in Washington. They also claim that the "source" of a taxpayer's income is the place where the services were actually performed.

Although the Tax Commission adopted most of petitioners' allegations as to the nature of the law firm's Washington law practice in its findings of fact, it nevertheless rejected petitioners' conclusion that none of their income was derived or connected with New York. The Tax Commission employed the "direct accounting" method of allocating income, which is the preferred method of allocating New York income (*see, Matter of Ward* v *New York State Tax Comm.*, 97 AD2d 640; *Matter of Bradford & Co.* v *State Tax Comm.*, 62 AD2d 69; *see also,* 20 NYCRR 131.15 [b]). The allocation method was based on information the law firm had submitted to tax authorities, which indicated that the law firm kept separate accounts of the income and expenses of each of its offices. The Tax Commission here, as it did in *Matter of Debevoise* v *State Tax Comm.* (52 AD2d 1023), allocated petitioners' income according to the proportion that partnership net income from sources outside New York bore to partnership net income from all sources. The record demonstrates that petitioners are members of a partnership which derives most of its income from New York.

The burden is on petitioners to prove that the Tax Commission's deficiency assessment was improper (Tax Law

§ 689 [e]; *Matter of Yohalem* v *State Tax Comm.*, 70 AD2d 996). They have not done so. As the decision of the Tax Commission is not arbitrary or capricious and is supported by substantial evidence, it must be confirmed (*see, Matter of Blasky* v *State Tax Comm.*, 69 AD2d 940).

Petitioners' argument that the method they used to determine their New York source income was in accord with the agreement reached in 1972 with then-Deputy Commissioner donovan and, therefore, using that alternative method, they are not liable for any New York tax, is rejected. There is no indication that the Tax Commission was prospectively bound by Donovan's decision. His letter at the time clearly stated that the Tax Commission reserved the right to change the method of allocating partnership income in future years. Thus, petitioners' belief that the Donovan decision would not be revoked in future years was not warranted by the facts. Petitioners' claim that the Tax Commission should be estopped from revoking the Donovan ruling in this case must also be rejected. Estoppel is generally not employable against the State or a government subdivision, particularly where the Tax Commission is involved (*see, Matter of Turner Const. Co.* v *State Tax Comm.*, 57 AD2d 201, 203; *cf. Matter of Petrie Stores Corp.* v *Tully*, 80 AD2d 328, 330).

Petitioners' contention that application of the tax violates the due process clauses of both the State and Federal Constitutions (US Const, 14th amend; NY Const, art I, § 6), on the basis that there is no appreciable connection between petitioners and New York, is without merit. The connection is significant. Petitioners are partners in a law firm that maintains a considerable permanent practice in New York. Thus, there is a sufficient nexus between their income and New York to validate the tax in question (*see, Matter of Knapp* v *State Tax Comm.*, 67 AD2d 1024).

Petitioners' claim that the imposition of the tax violates the commerce clause of the Federal Constitution (US

Const, art I § 8) also lacks merit. Their entire argument is based on the assertion that they worked only in the firm's Washington office, ignoring the fact that the partnership also practiced in New York. The requirements necessary to pass constitutional muster are set out in the decision in *Complete Auto Transit* v *Brady* (430 US 274), and they are met in this case (*see, Metropolitan Package Store Assn.* v *Koch*, 89 AD2d 317, 323, *appeal dismissed* 58 NY2d 1112, *appeal dismissed* 464 US 802). There is a sufficient nexus to New York. The tax does not discriminate against interstate commerce since only that portion of petitioners' income which represents partnership earnings in New York is taxed. The tax is fairly apportioned since it is only levied on the percentage of the law firm's income that was earned in New York. And, lastly, the tax is fairly related to services provided by New York (*see, Matter of Knapp* v *State Tax Comm., supra*).

We reject petitioners' argument that the imposition of the tax in this case would violate the privileges and immunities clause (US Const. art IV, § 2; 14th amend), in that New York residents are granted a credit against their New York taxes for any income tax paid to other jurisdictions but nonresidents subject to New York income taxes are denied a comparable credit (*see,* Tax Law §§ 620, 635). Tax Law § 620 (a) applies only to non-New York income. Petitioners' income which is taxed is New York income. They are not being denied any benefit which inures to New York residents. New York residents are taxable on New York income by virtue of their residency in New York. Non-New Yorkers, however, are not taxed on non-New York income.

Petitioners' assertion that the taxing of their income violates their right to equal protection, since they as a group are being treated less favorably than others under similar circumstances (US Const, 14th amend; NY Const, art I, § 11), is not persuasive. Petitioners, as partners in a law firm with its main office in New York, are carrying

on a profession in this State (*see*, Tax Law § 632 [b] [1] [B]). This is not true of employees of the Washington office or of out-of-State attorneys who are not members of a New York law firm. Thus, petitioners are not treated less favorably than others in similar circumstances.

Finally, the argument that, in any event, petitioners Hickey and Dye are exempt from the tax in question since they were employees of the law firm rather than partners, also lacks merit. It is argued that they were "junior partners" and that junior partners were not true partners, but employees. However, the Tax Commission found that Hickey and Dye were partners for tax purposes. This finding is supported by substantial evidence. A partnership is defined as "an association of two or more persons to carry on as co-owners a business for profit" (Partnership Law § 10 [1]). In determining the existence of a partnership, "[t]he receipt by a person of a share of the profits of a business is prime facie evidence that he is a partner in the business" (Partnership Law § 11 [4]).

In the instant case, it is clear that junior partners received a share of the profits, albeit a small share, in addition to their salary. Junior partners were also subject to liability for law firm losses, a significant element of a partnership (*see, Matter of Steinbeck* v *Gerosa*, 4 NY2d 302, 317, *appeal dismissed* 358 US 39). Hickey and Dye also chose to hold themselves out as partners and, having done so in circumstances such as these, can be required to accept the tax consequences of their decision (*see, Matter of Weinflash* v *Tully*, 93 AD2d 369, 373; *Matter of Faulkner, Dawkins & Sullivan* v *State Tax Comm.*, 63 AD2d 764). Thus, Hickey and Dye were properly held subject to the tax as nonresident partners of the firm (*see*, Tax Law § 637 [a] [1]).

Determination confirmed, and petition dismissed, without costs.

MAIN, J.P., CASEY, MIKOLL, YESAWICH, JR., and HARVEY, JJ., concur.

APPENDIX D

STATE OF NEW YORK
STATE TAX COMMISSION

In the Matter of the Petition
of
RONALD A. AND MARGARET L. CAPONE

for Redetermination of a Deficiency or for Refund of New York State Personal Income Tax under Article 22 of the Tax Law for the Years 1976 through 1979 and New York City Nonresident Earnings Tax under Chapter 46, Title U of the Administrative Code of the City of New York for the Years 1976 through 1979.

In the Matter of the Petition
of
RUSSELL T. AND VIRGINIA L. WEIL

for Redetermination of a Deficiency or for Refund of New York State Personal Income Tax under Article 22 of the Tax Law for the Years 1976 and 1977 and New York City Nonresident Earnings Tax under Chapter 46, Title U of the Administrative Code of the City of New York for the Years 1976 and 1977.

In the Matter of the Petition
of
ROBERT J. AND ELEANOR L. HICKEY

for Redetermination of a Deficiency or for Refund of New York State Personal Income Tax under Article 22 of the Tax Law for the Years 1976 through 1979 and New York City Nonresident Earnings Tax under Chapter 46, Title U of the Administrative Code of the City of New York for the Years 1976 through 1979.

In the Matter of the Petition
of
STUART S. AND MARY I. DYE

for Redetermination of a Deficiency or for Refund of New York State Personal Income Tax under Article 22 of the Tax Law for the Years 1976 and 1977 and New York City Nonresident Earnings Tax under Chapter 46, Title U of the Administrative Code of the City of New York for the Years 1976 and 1977.

DECISION

Petitioners Ronald A. and Margaret L. Capone, 3134 North Piedmont Street, Arlington, Virginia 22207, filed a petition for redetermination of a deficiency or for refund of New York State personal income tax under Article 22 of the Tax Law for the Years 1976 through 1979 and New York City nonresident earnings tax under Chapter 46, Title U of the Administrative Code of the City of New York for the years 1976 through 1979 (File Nos. 30420 and 30436).

Petitioners Russell T. and Virginia L. Weil, c/o Kirlin, Campbell & Keating, The Connecticut Building, 1150 Connecticut Avenue N.W., Suite 800, Washington, D.C. 20036, filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the years 1976 and 1977 and New York City nonresident earnings tax under Chapter 46, Title U of the Administrative Code of the City of New York for the years 1976 and 1977 (File No. 30468).

Petitioners Robert J. and Eleanor L. Hickey, 5601 Lambeth Road, Bethesda, Maryland 20014, filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the years 1976 through 1979 and New York City nonresident earn-

ings tax under Chapter 46, Title U of the Administrative Code of the City of New York for the years 1976 through 1979 (File Nos. 30462 and 31940).

Petitioners Stuart S. and May I. Dye, 5511 Parkston Road, Bethesda, Maryland 20016, filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the years 1976 and 1977 and New York City nonresident earnings tax under Chapter 46, Title U of the Administrative Code of the City of New York for the years 1976 and 1977 (File No. 30592).

A formal hearing was commenced before Arthur Bray, Hearing Officer, at the offices of the State Tax Commission, Two World Trade Center, New York, New York, on October 2, 1981 at 10:30 A.M. and concluded at the same offices on October 28, 1981, with all briefs to be submitted on or before September 9, 1983. Petitioners appeared *pro se*. The Audit Division appeared by Ralph J. Vecchio, Esq. (Kevin A. Cahill, Esq., of counsel).

ISSUES

I. Whether it is unconstitutional to apply section 637 of the Tax Law to petitioners.

II. Whether the agreement between Kirlin, Campbell & Keating and Deputy Commissioner Donovan constituted an agreement pursuant to section 637(d) of the Tax Law; if not, whether such agreement should nonetheless be followed; and whether the failure to follow this agreement constituted an improper retroactive cancellation of the agreement.

III. Whether the incomes of the petitioners were attributable to a New York source and therefore taxable by New York State and New York City.

IV. Whether the notices of deficiency erroneously understated the ratio of Washington office net income to the net partnership income for 1976 and 1977 by failing to consider the compensation paid to the Washington and New York junior partners as an expense.

FINDINGS OF FACT

1. On April 3, 1980, the Audit Division issued a Notice of Deficiency, accompanied by an explanatory Statement of Audit Changes to petitioners Ronald A. Capone and Margaret L. Capone, asserting a deficiency of New York State personal income tax and New York City nonresident earnings tax for the years 1976 and 1977. The Notice asserted a total deficiency of tax of $31,029.36, plus interest of $6,290.65, for a total amount due of $37,320.01. On April 28, 1980, the Audit Division issued two notices of deficiency, with accompanying statements of audit changes, to petitioners Ronald A. Capone and Margaret L. Capone, asserting deficiencies of New York State personal income tax and New York city nonresident earnings tax for, respectively, the years 1978 and 1979. The Notice for the year 1978 asserted a deficiency of $14,169.27, plus interest of $1,247.31, for a total amount due of $15,416.58. The Notice for the year 1979 asserted a deficiency of $15,600.87, plus interest of $47.26, for a total amount due of $15,648.13.

2. On June 20, 1980, petitioners Ronald A. Capone and Margaret L. Capone, filed petitions for redetermination of the above-mentioned notices of deficiency. On December 18, 1980, they submitted payments to the Audit Division of $39,957.51 for 1976 and 1977, $16,620.97 for 1978 and $16,973.77 for 1979 and they amended their petitions to claim a refund of said payments. The purpose of the payments was to stop the accrual of interest.

3. On April 14, 1980, the audit Division issued a Notice of Deficiency, accompanied by an explanatory Statement

of Audit Changes, to petitioners Russell T. Weil and Virginia L. Weil, asserting a deficiency of New York State personal income tax and New York City nonresident earnings tax for the years 1976 and 1977. The tax asserted to be due was $12,592.69, plus interest of $2,600.21, for a total amount due of $15,192.90.

4. On April 14, 1980, the Audit Division issued a Notice of Deficiency, accompanied by an explanatory Statement of Audit Changes, to petitioners Robert J. Hickey and Eleanor L. Hickey, asserting a deficiency of New York State personal income tax and New York City nonresident earnings tax for the years 1976 and 1977. The total amount of the deficiency of tax asserted was $9,072.11, plus interest of $1,824.41, for a total amount due of $10,896.52. On October 1, 1980, the Audit Division issued a Notice of Deficiency, accompanied by an explanatory Statement of Audit Changes, to petitioners Robert J. Hickey and Eleanor L. Hickey, asserting a deficiency of New York State personal income tax and New York City nonresident earnings tax for the years 1978 and 1979. The total tax asserted to be due in the latter Notice was $14,328.63, plus interest of $1,037.97, for a total amount due of $15,366.42.

5. On April 14, 1980, the audit Division issued a Notice of Deficiency, accompanied by an explanatory Statement of Audit Changes, to petitioners Stuart S. Dye and Mary 1. Dye, asserting a deficiency of New York State personal income tax and New York nonresident earnings tax plus interest for the years 1976 and 1977. The total amount of tax allegedly due was $7,167.88, plus interest of $1,536.24, for a total of $8,704.12.

6. The statements of audit changes which accompanied each of the foregoing notices of deficiency stated, in substance, that each of the petitioners[1] were partners in a

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[1] Unless otherwise stated, references to petitioners shall be a reference to Ronald A. Capone, Russell T. Weil, Robert J. Hickey and Stuart S. Dye.

partnership which did business both within and without the State and City of New York. Accordingly, the Audit Division determined that New York State personal income tax and New York City nonresident earnings tax were due based upon an allocation percentage computed by the Audit Division and the distributive shares of partnership income reported by the partnership on its partnership returns as distributed to each partner. In determining the partnership's allocation percentage, the Audit Division did not treat the compensation of the junior partners as an expense. Instead, such compensation was added to the partnership net income and the Washington office net income.

7. Kirlin, Campbell & Keating (hereinafter "the partnership") is a partnership engaged in the full-time practice of law with offices in Washington, D.C. (the "Washington office") and New York City (the "New York City office").

8. During the years 1976 through 1979, petitioner Ronald A. Capone was a resident senior partner of the Washington office. Petitioner Russell T. Weil was a resident senior partner of the Washington office during the years 1976 and 1977. Petitioner Robert J. Hickey was a resident junior partner of the Washington office during 1976 an remained in that status until July, 1978 when he became a senior partner. Petitioner Stuart S. Dye was a resident junior partner of the Washington office during the years 1976 and 1977.

9. During the years in issue, Mr. & Mrs. Capone were residents of and filed income tax returns with the State of Virginia. Mr. and Mrs. Capone did not file New York State income tax returns or New York City nonresident earnings tax returns for the years 1976 through 1978. They did file a joint New York State Income Tax Nonresident Return for the year 1979. Mr. Capone indicated on this return, however, that he did not have any income subject to New York State tax.

10. During their respective years in issue, Russell T. Weil, Robert J. Hickey and Stuart S. Dye were residents of and filed tax returns with the State of Maryland.

11. Mr. and Mrs. Weil did not file New York State or New York City tax returns for the years 1976 and 1977.

12. Mr. and Mrs. Hickey did not file New York State or New York City tax returns for the years 1976 and 1977. They did file New York State income tax nonresident returns for the years 1978 and 1979. On the 1978 and 1979 returns, Robert J. Hickey attached a comment which stated that, based upon a determination of Deputy Commissioner Donovan, there was no New York income.

13. Mr. and Mrs. Dye did not file New York State or New York City tax returns for the years 1976 and 1977.

14. During the years in issue, each of the petitioners was a member of the District of Columbia bar and was not admitted to practice and did not practice law in New York State. All of their professional services were performed in the Washington office. None of the petitioners maintained an office or work space in New York during the years in question.

15. The status of Mr. Capone, Mr. Weil, Mr. Hickey and Mr. Dye, as partners with the Washington office, was held out to the public by the partnership's letterhead and the partnership's listing in the *Martindale-Hubble Law Directory*.

16. All matters handled by petitioners, during the years in issue, were the results of petitioners' activities in the Washington office, except for certain matters that generated relatively low fees compared to the total Washington income.

17. The substantive data on Washington office client matters, such as retainer agreements, time sheets and billable hours, were kept at the Washington office.

18. The partnership's Washington office maintained a bank account in the District of Columbia which was separate from the bank account maintained by the New York City office. Most of the fees generated by the Washington office were billed, collected and deposited by the Washington office into this account. There were instances, however, where services were rendered to the same client by both the New York and Washington offices. In such instances, the fees generated by the Washington office were billed and collected through the New York office based upon fees determined by the Washington office.

19. The fees and disbursements collected for the Washington office have, during the years in issue, been more than sufficient to cover all expenses in maintaining the Washington office, including compensation, rent and supplies. The records of gross receipts and expenses were maintained on an allocated basis during the years in issue between the New York and Washington offices. The net income of the Washington office was sufficient to meet all expenses and to provide a net flow of funds to the partners situated in New York. Failure to show a profit would have resulted in terminating the Washington partners' relationship with the New York firm.

20. During each of the years in issue, the income and expenses were reported to the partnership's accounting firm which, in turn, prepared the New York State partnership returns. The form IT-204A, encaptioned New York State Nonresident Partner Allocation Schedule, listed each of the petitioners as nonresident partners, during the respective years in issue, but stated that none of the petitioners' incomes was attributable to New York. Each of the petitioners was issued a schedule K-1, Partner's Share of Income, Credits, Deductions, etc., by the partnership during the respective years in issue. The partnership did not withhold taxes or social security from any compensation received by petitioners during the respective years in issue.

21. The partnership's bookkeeping department, which was located in New York, issued all payroll checks. This office would also file all necessary federal forms. A portion of the expense of operating the bookkeeping department was allocated to the Washington office.

22. During the years in issue, it was the policy of the partnership that the compensation of the junior partners would be set at a level that was commensurate with that which attorneys of comparable skills and experience were receiving from other firms. However, the partnership did not try to meet the market price of some of the larger firms that were able to compensate attorneys at the higher levels.

23. Paragraph II of the partnership agreement, dated January 1, 1977, provided that junior partners were not required to sign the partnership agreements. However, said paragraph also provided that "... each Junior Partner shall execute an individual letter consenting to join the Firm, subject to the terms and conditions of this Agreement".

24. In accordance with the foregoing paragraph, when Mr. Hickey and Mr. Dye were invited to become junior partners with the Washington office, they were sent a letter by Mr. Capone. In each instance, the letter set a fixed rate of compensation. The letters also stated that a junior partnership "does not involve any participation in the profits or assets of the Firm".

25. Paragraph III of the partnership agreements placed all of the Firm's partners into one of two categories. Partners with 3,000 or more units were considered class A, or senior partners, and those with 3,000 or less units were considered class B, or junior partners. This paragraph further provided:

> "Each Partner shares in the joint and several liability and responsibility of all Partners regard-

> less of their classification. It is agreed that each Class B or Junior Partner makes no contribution to the firm's Capital Account. Each Class B or Junior Partner hereby waives any interest or right in the firm's Capital Account, or in the Firm's name, or in the Firm's goodwill or other assets of the Firm, except as otherwise provided for in this Agreement."

26. As junior partners, Mr. Hickey and Mr. Dye were accorded fifty units. The fifty units given to each of the partnership's junior partners represented an interest of approximately .0002 percent in the partnership's net income.[2] The incomes of petitioners Robert J. Hickey and Stuart S. Dye, as junior partners, were not dependent on the partnership's profits and losses.

27. Paragraph V of the partnership agreements provided, in part, in regard to net income and allocation, that the compensation paid to class B or junior partners was to be treated as an expense.

28. The management of the partnership was generally placed in a "Management Committee" consisting of selected individuals. The Management Committee could delegate authority to act to a subcommittee. The junior partners waived their rights in the management and conduct of the partnership and did not participate in decision making. Similarly, they waived their right to see or inspect any of the partnership's books or financial documents and their right to a formal accounting.

29. It was expressed to petitioners Robert J. Hickey and Stuart S. Dye, as junior partners, that it was the

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[2] The actual interest of the junior partners in the partnership's net income was slightly greater. In view of the partnership's net income during the years in issue a distribution to the junior partners based upon their interest in the partnership's net income was not *de minimis*.

intent of the partnership to treat the junior partners as employees.

30. On May 29, 1969, Mr. Louis A. Palladino of the Unemployment Insurance Accounts Bureau of the New York State Department of Labor advised the partnership that the junior partners were employees. The partnership disagreed with the Department of Labor's conclusion and, consequently, the case was forwarded to a hearing. The outcome of this hearing is not disclosed by the record.

31. In November, 1971, the Audit Division initiated an investigation as to whether there was a deficiency of personal income tax from petitioner Ronald A. Capone for the years 1967 and 1968. The investigation also included Russell T. Weil who, at the time, was a junior partner.

32. On October 12, 1972, a conference was held in Albany between petitioners Ronald A. Capone, Russell T. Weil and a Mr. Sheehan, who was a partner associated with the New York office, and Deputy Commissioner Donovan, who at the time was the Director of the Income Tax Bureau, as well as other individuals representing the Income Tax Bureau. One portion of this conference was directed to whether the junior partners, such as Mr. Weil, should be considered employees. Another portion of the conference was directed to whether Mr. Capone, as a senior partner, should be required to pay New York income tax. At the conclusion of the hearing, Deputy Commissioner Donovan decided that further consideration was needed and he asked that the partnership agreement, as well as briefs discussing the situation of Mr. Capone and the junior partners, be filed.

33. On November 13, 1972, Deputy Commissioner Donovan advised Mr. Capone, by telephone, that Mr. Capone's file would be closed and that Mr. Capone would have no tax liability for prior years on the theory that the Washington office's income exceeded the costs of the Washington office and Mr. Capone's share of the partnership

income. Deputy Commissioner Donovan also advised Mr. Capone that steps would be taken to assert tax liability if the New York partners' deduction for Washington office income plus Mr. Capone's share exceeded the Washington office's income.

34. In a letter dated November 22, 1972, Deputy Commissioner Donovan advised Mr. Sheehan of the following decision:

> "With respect to the Messrs. Weil and . . ., I have concluded that they were employees of Kirlin, Campbell & Keating. Since they were not residents of New York State and did not perform any services within New York State, they are not subject to tax on the salaries received from the partnership.
>
> I have decided not to ask Mr. Capone to file returns for the years 1967 through 1971. The manner in which the nonresident partners attached to the New York office reported their distributive shares of income resulted in tax revenue to the State of New York in an aggregate amount approximating the revenue which would result if I were to insist upon Mr. Capone filing returns for the years 1967 through 1971.
>
> For subsequent years, I must reserve the right to require a change in the method of reporting partnership income on the individual nonresident returns for any year in which the State of New York would suffer a loss in tax revenue."

35. In reliance upon the method set forth by Deputy Commissioner Donovan, petitioners did not sever their relations with the partnership or attempt to terminate or rearrange the New York office/Washington office arrangement. Moreover, petitioner Ronald A. Capone periodically advised each individual whom he invited to become a junior

partner that the Washington office had to make every effort to increase net income and keep expenses down as much as possible to be certain that there would be no tax exposure arising from the New York office. The junior partners were specifically advised of Mr. Donovan's letter agreement, as well as of his telephone conversation of November 13, 1972.

36. Each of the Washington office's petitioners settled their accounts between the partners and otherwise planned their personal affairs in reliance upon Mr. Donovan's agreement. It is not possible to retroactively reorganize the financial arrangements and settlement of accounts between petitioners and the New York partners.

37. On March 1, 1978, a letter was sent out under the name of Mr. Joseph Styno, as an employee of the Audit Division, requesting petitioners to file returns for the year 1974. Mr. Styno was not aware of the letter at the time it was sent. On March 15, 1978, Mr. Sheehan replied to the letter and, among other things, called the Audit Division' attention to the Donovan letter of November 22, 1972. In a letter dated April 20, 1978, the Audit Division replied that the agreement entered into with Deputy Commissioner Donovan did not apply to the year 1974. In addition, the Audit Division indicated that it was going to expand the scope of the audit to encompass the year 1975 and subsequent years.

38. In a letter dated April 20, 1978, Mr. Styno acknowledged that the activities of the partnership had not changed since 1972. He opined, however, that section 637 of the Tax Law precluded the method of reporting income agreed to by Deputy Commissioner Donovan.

39. On March 23, 1980, petitioners' Capone, Weil and Hickey, together with two partners of the New York office, had a conference with the Director of the Audit Division and other persons in the Audit Division. At this meeting, the Director disagreed with petitioners' conten-

tions and, thereafter, the notices of deficiency which are the subject of this proceeding were issued.

40. In accordance with section 307(1) of the New York State Administrative Procedure Act, petitioners' proposed findings of fact have generally been accepted and the substance thereof adopted herein. However, the following major change are noted: Proposed findings of fact 10, 14, 16, 17, 18, 19, 20, 22, 28, 31 and 34 have been rejected either in total or in part because they are either redundant or unnecessary to the determination. It is noted that proposed finding of fact 24 is also not fully supported by the record inasmuch as Robert J. Hickey and Stuart S. Dye did, in fact, sign the partnership agreement dated September 1, 1976. Proposed finding of fact 35 is rejected as argumentative and Finding of Fact 26 is substituted in its place.

CONCLUSIONS OF LAW

A. That the constitutionality of the laws of the State of New York is presumed at the administrative level.

B. That subdivision (d) of section 637 of the Tax Law provides:

> "*Alternate methods.*—The tax commission may, on application, authorize the use of such other methods of determining a nonresident partner's portion of partnership items derived from or connected with New York sources, and the modifications related thereto, as may be appropriate and equitable, on such terms and conditions as it may require."

That since there is nothing in the record to suggest that an application was made to the State Tax Commission to authorize petitioners' method of reporting income and that the State Tax Commission, in turn, approved of petitioner's method of reporting income, the arrangement approved by

Deputy Commissioner Donovan may not be considered an alternate method under section 637(d) of the Tax Law.

C. That the method approved by Deputy Commissioner Donovan pertained to the years 1967 to 1971 alone. It is noted that Deputy Commissioner Donovan expressly reserved the right to change the method of reporting partnership income on the individual nonresident returns for subsequent years. Accordingly, there has not been a retroactive change in the agreement entered into with Deputy Commissioner Donovan. It is noted that since the agreement is violative of other subdivisions of section 637 of the Tax Law (see Conclusion of Law "E", *infra*), whether or not there has been a loss of revenue to the State of New York is irrelevant. The State Tax Commission is not bound to follow an informal agreement that is not in conformity with the Tax Law of the State of New York.

D. That section 632(a)(1) of the Tax Law provides, in substance, that the New York adjusted gross income of a nonresident individual shall include the sum of the net amount of the items of income, gain, loss and deduction entering into that individual's federal adjusted gross income which are derived from or connected with New York sources. Section 632(a)(1)(A) of the Tax Law further provides that these items include the nonresident individual's ". . . distributive share of partnership income, gain, loss and deduction, determined under section six hundred thirty-seven. . .". The income subject to the New York City nonresident earnings tax is computed in the same manner [Administrative Code of the City of New York, §§U46-1.0(f); U46-4.0(a)].

E. That section 637(a)(1) of the Tax Law, in defining the portion of income derived from New York sources, provides:

> "In determining New York adjusted gross income of a nonresident partner of any partnership, there shall be included only the portion derived

> from or connected with New York sources of such partner's distributive share of items of partnership income, gain, loss and deduction entering into his federal adjusted gross income, as such portion shall be determined under regulations of the tax commission consistent with the applicable rules of section six hundred thirty-two."

F. That since it is acknowledged that Ronald A. Capone and Russell T. Weil were nonresident partners of a New York partnership, the Audit Division properly concluded that they were taxable upon their distributive share of partnership income which was attributable to the partnership's activities in New York (Tax Law §637(a)(1); *see Matter of Weinflash v. Tully*, 93 A.D.2d 369, 373).

G. That petitioners Stuart S. Dye and Robert J. Hickey are considered partners of Kirlin, Campbell & Keating for tax purposes during the respective periods that they served as junior partners. It is recognized that said petitioners had a small interest in the profits of the partnership, received a fixed salary, and did not participate in the management of the firm. Nevertheless, since petitioners chose to be designated partners and were held out to the public as partners, they must accept the tax consequences of their decision (*Matter of Weinflash v. Tully, supra; see Matter of Faulkner, Dawkins & Sullivan v. State Tax Comm.*, 63 A.D.2d 764).

H. That section 637(b)(1) of the Tax Law provides, in part:

> "In determining the sources of a nonresident partner's income, no effect shall be given to a provision in the partnership agreement which—
>
> (1) characterizes payments to the partner as being for services or for the use of capital,. . .".

I. That in view of section 637(b)(1) of the Tax Law, the Audit Division properly determined that the payments to

the junior partners were distributions of partnership income which were connected with New York State and subject to New York State and New York City taxation (*see Matter of Baum v. State Tax Comm.*, 89 A.D.2d 646, 647, mot. for lv. to app. den. 57 N.Y.2d 607; *cf., Matter of Faulkner, Dawkins & Sullivan v. State Tax Comm., supra*).

J. That the petitions and amended petitions of Ronald A. and Margaret L. Capone are denied and the Audit Division is directed to determine whether the payments (see Finding of Fact "2", *supra*) resulted in an underpayment or overpayment of the notices of deficiency which are sustained.

K. That the petitions of Russell T. and Virginia L. Weil, Robert J. and Eleanor L. Hickey and Stuart S. and Mary I. Dye are denied and the notices of deficiency are sustained.

Dated: Albany, New York

STATE TAX COMMISSION

/s/ RODERICK G.W. CHU
PRESIDENT

/s/ FRANCIS R. KOENIG
COMMISSIONER

/s/ MARK FRIEDLANDER
COMMISSIONER

APPENDIX E

COURT OF APPEALS
STATE OF NEW YORK

Albany Co.
Clerk's
Index Nos.
13170-84,
13171-84,
13172-84,
and
13173-84

IN THE MATTER OF RUSSELL T. WEIL and VIRGINIA L. WEIL, STUART S. DYE and MARY I. DYE, ROBERT J. HICKEY and ELEANOR L. HICKEY, and RUSSELL T. WEIL, RONALD L. CAPONE, and JILDA C. GARITY, as Executor, Administrator cta, and Administratix cta, respectively, of the Estates of Ronald A. Capone and Margaret L. Capone, deceased,

Appellants,

- against -

RODERICK G.W. CHU, FRANCIS KOENIG, and MARK FRIEDLANDER, constituting the State Tax Commission of the State of New York,

Respondents.

NOTICE OF APPEAL TO THE SUPREME COURT OF THE UNITED STATES

Notice is hereby given that Russell T. Weil *et al.*, the Appellants above-named, hereby appeal to the Supreme Court of the United States from the final judgment of the Court of Appeals of the State of New York, affirming the decision of the Appellate Division, Third Department, entered in this action on October 15, 1987.

This appeal is taken pursuant to 28 U.S.C. §1257(2).

Dated: November 13, 1987

Yours, etc.,
/s/ ERNESTO V. LUZZATTO
ERNESTO V. LUZZATTO
Attorney for Appellants
14 Wall Street
23rd Floor
New York, N.Y. 10005

To: Clerk of the Court of Appeals

Clerk of the Supreme Court, County of Albany

Francis V. Dow, Esq.
Assistant Attorney General,
State of New York
Justice Building
Albany, N.Y. 12224

No. 87-1179

Supreme Court, U.S.
FILED
FEB 9 1988
JOSEPH F. SPANIOL, JR.
CLERK

IN THE

Supreme Court of the United States

October Term, 1987

RUSSELL T. WEIL and VIRGINIA L. WEIL, STUART S. DYE and MARY I. DYE, ROBERT J. HICKEY and ELEANOR L. HICKEY, and RUSSELL T. WEIL, RONALD A. CAPONE, and JILDA C. GARITY, as Executor, Administrator cta, and Administratrix cta, respectively, of the Estates of Ronald A. Capone and Margaret L. Capone,

Appellants,

against

RODERICK G. W. CHU, FRANCIS KOENIG, and MARK FRIEDLANDER, constituting the State Tax Commission of the State of New York,

Appellees.

ON APPEAL FROM THE COURT OF APPEALS OF THE STATE OF NEW YORK

MOTION TO DISMISS OR AFFIRM

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Dated: February 5, 1988

Questions Presented

1. Whether New York may tax nonresident partners of a New York partnership on their allocated distributive share of income from the partnership without violating the due process, equal protection, commerce, and the privilege and immunities clauses of the United States Constitution, where the nonresident partners perform no services for the partnership in New York.

2. Whether New York Tax Law § 620, which gives residents but not nonresidents, a credit against New York income taxes for income taxes paid to other jurisdictions violates the privileges and immunities, the equal protection nor the commerce clause of the United States Constitution.

3. Whether the United States Constitution was violated by the termination, effective for years after 1975, of a letter agreement in which the filing of New York income tax returns requirement was waived for the years 1967 through 1971 for employees and a nonresident partner who performed services outside of the state for a New York partnership.

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No. 87-1179

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1987

RUSSELL T. WEIL and VIRGINIA L. WEIL, STUART S. DYE and MARY I. DYE, ROBERT J. HICKEY and ELEANOR L. HICKEY, and RUSSELL T. WEIL, RONALD A. CAPONE, and JILDA C. GARITY, as Executor, Administrator cta, and Administratrix cta, respectively, of the Estates of Ronald A. Capone and Margaret L. Capone,

Appellants,

v.

RODERICK G.W. CHU, FRANCIS KOENIG, and MARK FRIEDLANDER, constituting the State Tax Commission of the State of New York,

Appellees.

ON APPEAL FROM THE COURT OF APPEALS OF THE STATE OF NEW YORK

MOTION TO DISMISS OR AFFIRM

The appellees move the Court to dismiss the appeal herein or, in the alternative, to affirm the judgment of the Court of Appeals of the State of New York on the ground that

it is manifest that the questions on which the decision of the cause depends are so insubstantial as not to need further argument.

Counterstatement of Facts

The appellants[1] during the years in issue were partners in the firm of Kirlin, Campbell and Keating, a partnership which is engaged in the practice of law in New York City and Washington, D.C. Capone resided in Virginia. Weil, Hickey and Dye resided in Maryland.

Notices of deficiency for New York State personal income and New York City earnings were issued to the appellants for the years 1976 through 1979, except as noted hereafter, on the basis that they were subject to the taxes on their allocable distributive share of income from the partnership connected with those jurisdictions.

Although Weil was a member of the partnership during 1976 through 1979, deficiencies were issued to him only for 1976 and 1977. Dye was a member of the partnership only during 1976 and 1977 and deficiencies were issued to him only for those years.

The appellants performed services for the partnership in its Washington office. They were not admitted to the New York State Bar and had no office space in New York City. They performed no services for the partnership in New York. Under provisions of the agreements of the partners, however, all gross fees earned by the partners constituted

---

[1]The term "appellants" here refers to Ronald A. Capone (Capone), Russell T. Weil (Weil), Robert J. Hickey (Hickey) and Stuart S. Dye (Dye). The spouses of these attorneys are also appellants, but are not discussed hereafter. Ronald A. Capone and his spouse are now deceased; their executor, administrator c/t/a and administratrix c/t/a were substituted in the court below as appellants herein.

fees of the partnership and did not belong to the individual partners. Partners were entitled to receive a distributive share of the net fees and were liable for the losses of the partnership. The allocation of income by the Department was determined from information contained in the file of the New York State Department of Taxation and Finance showing that the partnership income was allocable to New York and Washington as follows:

	New York	Washington
1976	76.9%	23.1%
1977	80.1%	19.9%
1978	74%	26%
1979	79.32%	20.68%

The partnership maintained records of gross receipts and expenses allocated between the New York and Washington offices. During each of the years in issue, the income and expenses of both offices were reported to the partnership's accounting firm which prepared New York State partnership returns. On these returns, each of the appellants was listed a nonresident partner but none of the appellants' income was allocated to New York as its source.

The partnership bookkeeping department, which was located in New York, issued all payroll checks and filed all necessary federal tax forms. A portion of the expense of operating the bookkeeping department was allocated to the Washington office.

The fees generated by the appellants were the result of their activities in the Washington office except for certain matters that generated relatively low fees compared to the other Washington income. Fees earned by the Washington office were billed, collected and deposited by that office.

Data and Washington client matters such as retainer agreements, time sheets and billable hours were kept in the Washington office. It maintained a bank account in the District of Columbia which was separate from the bank account maintained by the New York City office. There were instances where services were rendered to the same client by both the New York and Washington offices. In such instances, fees earned in Washington were billed and collected through the New York office upon fees determined by the Washington office. Fees and disbursements collected by the Washington office were more than sufficient to cover all expenses in maintaining that office as well as the payment of the Washington partners' distributive shares of income.

Following an audit of the partnership's New York tax returns for years prior to the years in issue, a conference had been held in Albany on October 12, 1972 to resolve a potential New York income tax liability of Capone and Washington employees of the firm, including Weil. A portion of the meeting dealt with whether Capone, as a Washington-based nonresident partner, should be required to pay New York income taxes on his income from the partnership. At that time it appeared that nonresident partners working in the New York City office of the partnership were not allocating their shares of partnership income between New York and Washington but were reporting their entire partnership distributive shares as New York City source income.

On November 13, 1972, Capone was advised by telephone that he would have no New York tax liability for 1967 through 1971 on the theory that the Washington office's income exceeded the costs of the Washington office and Capone's share of partnership income. In a letter dated November 22, 1972, a New York State Deputy Tax Commissioner advised the partnership that:

"With respect to the Messrs. Weil and Binder, I have concluded that they were employees of Kirlin, Campbell & Keating. Since they were not residents of New York State aand did not perform any services within New York State, they are not subject to tax on the salaries received from the partnership.

"I have decided not to ask Mr. Capone to file returns for the years 1967 through 1971. The manner in which the nonresident partners attached to the New York office reported their distributive shares of income resulted in tax revenue to the State of New York in an aggregate amount approximating the revenue which would result if I were to insist upon Mr. Capone filing returns for the years 1967 through 1971.

"For subsequent years, I must reserve the right to require a change in the method of reporting partnership income on the individual nonresident returns for any year in which the State of New York would suffer a loss in tax revenue."

The record shows that subsequent to 1975 nonresident partners in the New York office of the partnership were allocating their distributive shares of income from the partnership between New York and Washington. On March 1, 1978 the New York State Department of Taxation and Finance requested the appellants to file income tax returns for the year 1974. An audit of the members of the partnership was expanded to cover the year 1975 and subsequent years. Tax deficiencies were issued only for 1976 through 1979.

The appellants applied for an administrative hearing before the New York State Tax Commission for a redetermi-

nation of the tax deficiencies. Following the hearing, a determination was issued sustaining the deficiencies. Appellants' Jurisdictional Statement pp 12a-28a. The opinion of the New York State Supreme Court, Appellate Division, Third Department, confirmed the determination and is reported at 120 NY AD2d 781 (1986). The Court of Appeals of the State of New York affirmed the judgment of the Appellate Division on October 15, 1987. Its order is reported at 70 NY2d 783.

The appellants' Jurisdictional Statement was received on January 15, 1988.

ARGUMENT

POINT I

New York may tax nonresident partners of a New York partnershp on their allocated distributive share of income from the partnership connected with New York without violating the due process, equal protection, commerce and privilege and immunities clauses of the United States constitution, even where the nonresident partners perform no services in New York.

New York State and New York City impose taxes on the income of their residents. Under New York Tax Law §§ 601, 632 and 637,[2] an income tax is imposed on the New York allocated distributed share of income of nonresident partners derived from or connected with New York sources. New York City also imposes a similar nonresident earnings tax on New York City source income. Administrative Code of the City of New York, §§ 46.1.0(f); U46-4.0(a). Both jurisdictions compute taxable income similarly.

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[2]These sections were renumbered in 1987.

A nonresident partner's distributive share of income from a partnership doing business within and without New York, which is subject to tax by these jurisdictions, is that income from the partnership which is allocated to the New York offices of the partnership. New York Tax Law § 637; Reg. of the State Tax Commission § 131.13 (20 NYCRR 131.13). The allocation methods are similar to those used in allocating New York income of corporations doing business within and without the state, that is generally by using a three factor formula or by a direct accounting method.

State statutes or municipal ordinances imposing taxes upon the income of nonresident individuals that have sources within the taxing states or municipalities have been upheld as against constitutional challenges based on the due process clause (*see, Travis v. Yale & Towne Mfg. Co.*, 252 U.S. 60 [1920]); the privileges and immunities clause and the equal protection of the laws clause; (*American Commuters Assoc. v. Levitt*, 405 F.2d 1148 [2nd Cir. 1969]); and the commerce clause (*Shaffer v. Carter*, 252 U.S. 37 [1920]). *See also*, Hellerstein, Some Reflections on the State Taxation of Nonresidents Personal Income, 72 Mich. L. Rev. 1309, June 1974. The New York income taxes imposed on nonresident partners meet the requirements stated in *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977). There, this Court held a state tax must meet the following tests: (1) that the taxed activity must have a substantial nexus with the taxing state; (2) that the tax does not discriminate against interstate commerce; (3) that the tax is fairly apportioned and (4) that the tax is fairly related to services provided by the state.

The activity taxed here has a substantial nexus to New York. The taxed activity is the receipt or crediting of allocated income from a partnership which does business in New York. The partnership agreement provides that all income

of the partnership, whether it is earned from services performed in New York or elsewhere, belongs to the partnership. Nonresident partners of the firm have no separate property right in the income of the firm based on the services which they performed outside New York until it is distributed or credited them. *See*, Uniform Partnership Law, Part V, which has been adopted by most jurisdictions. The nonresident partners' share of income is dependent on the profitability of the partnership as a whole, even if the nonresident partners performing services in Washington, D.C. generate income that is more than sufficient to pay the expenses of the Washington office and their distributive shares. Their share of income under the partnership agreements is not dependent upon the services or the capital which they furnish to the firm.

There is no basis to the appellants' claim that the taxes place an undue burden on interstate commerce. The nonresident partners are not being taxed on income derived from sources outside New York. New York imposes taxes on New York income allocable to nonresident partners because they are receiving income from New York sources. It is only that New York source income which is being taxed by New York and New York City. The tax is thus fairly apportioned.

The income tax imposed on nonresident partners is reasonably related to the services provided by New York a partnership which does business in New York. *See*, *Commonwealth Edison v. Montana*, 453 U.S. 609, 617-627 (1981).

POINT II

New York Tax Law § 620, which gives residents, but not nonresidents, a credit against New York income taxes for income taxes paid to other jurisdictions does not violate the privileges and immunities, the equal protection nor commerce clauses of the United States Constitution.

Contrary to appellants' assertion (Jur. St., pp 32-38), the credit provided to residents under New York Tax Law § 620 is in no way discriminatory. A state's authority to tax residents is greater than its authority to tax nonresidents. Hence, credits for taxes paid to other states may differ. A resident individual may be taxed on his income both in the state in which he resides and in the state from which the income is derived without offending the Constitution. *Curry v. McCauless*, 307 U.S. 357, 368 (1969).

A resident taxpayer is subject to his state's plenary taxing power. *Shaffer v. Carter*, 252 U.S. 37, 52 (1920). With modifications not relevant here, a New York resident is subject to personal income taxes on his income derived from or connected with New York sources, as well as income derived from other jurisdictions, even though some or all of that income is taxed by another jurisdiction. New York Tax Law §§ 611, 612.

By contrast, New York taxes nonresidents only on income which is derived from or connected with New York sources. New York does not tax and constitutionally may not tax nonresidents on their non-New York source income. New York Tax Law §§ 631, 632; *Shaffer v. Carter*, *supra*, 252 U.S. at 52-53; *Travis v. Yale and Towne Mfg. Co.*, 292 U.S. 60, 75 (1920).

New York Tax Law § 620 allows New York resident taxpayers a credit, with certain limitations, against any New York income taxes, for any income tax imposed by another state (including the District of Columbia) "* * * upon income derived therefrom and subject to tax under this article (New York Tax Law, Article 22, Personal Income Tax)." The credit provided by section 620 applies exclusively to non-New York source income which is taxable by New York only by virtue of a taxpayer's New York residency. The credit seeks to avoid double taxation on income that, while properly taxable in New York, is not attributable to New York sources. With respect to New York source income, residents and nonresidents are treated alike. Neither receives a credit with respect to such income.[3] Thus, provisions of section 620 violate neither the privileges and immunities clause nor any other constitutional constraint.

The purpose of the privileges and immunities clause is to assure that no state distributes benefits and burdens in a manner that unduly disadvantages non-citizens of the state; the clause is designed to preclude the treatment of citizens of another state as aliens. *Toomer v. Witsell*, 334 U.S. 385, 395 (1948); *Travis v. Yale and Towne Mfg. Co.*, *supra*, 252 U.S. at 78 (quoting *Paul v. Virginia*, 8 Wall 168, 180 [1868]). A state generally may not impose a tax only

---

[3]The application of section 620 without consideration of exemptions and deductions is shown by the following examples: Resident A, resident B, and nonresident C each has a taxable income of $100,000. A pays no income taxes to any other state. He pays taxes in New York on his taxable income of $100,000, regardless of where that income is generated. B pays income tax to another state on $25,000 of his income. Under Tax Law § 620 he gets a credit for the taxes he paid the other state. B's total state taxes will be the same as A's, with 75% being paid to New York and 25% to the other state (assuming the tax rates, etc., are the same in both states). C's income of $100,000 is derived from New York sources to the extent of $75,000. He is taxed in New York solely on that $75,000 and receives no credit for taxes paid to any other jurisdiction on that or any other income.

on nonresidents (*Austin v. New Hampshire*, 420 U.S. 656 [1975]), or prevent nonresidents from participating in a particular trade or business. *Toomer v. Witsell, supra*. It has been held that the clause is not an absolute. It does not preclude disparate treatment of residents and nonresidents where there are valid reasons for such treatment other than the mere fact of nonresidency. *Toomer v. Witsell, supra*, 334 U.S. at 396; *see also, Matter of Goodwin v. State Tax Commission*, 286 App. Div. 694 (3d Dept. 1955), *affd*, 1 NY2d 680 (1956), *appeal dismissed*, 352 U.S. 805 (1956). The clause does not come into play at all unless there is real, rather than just apparent, discrimination against nonresidents. *Travelers' Insurance Co. v. Connecticut*, 185 U.S. 364 (1902).

Assuming *arguendo* that the clause applies here, the fact that only residents are taxed on their non-New York income provides a completely valid and logical reason to limit the credit to them. Since nonresidents pay no New York tax on non-New York income, no credit for taxes paid elsewhere on such income is appropriate.

Appellants' equal protection argument is similarly unavailing. As demonstrated above, any discrimination arguably created by section 620 between residents and nonresidents is a rational one, which is all that equal protection requires. *Lehnhausen v. Lake Shore Auto Parts Co.*, 410 U.S. 356, 363-64 (1973). The credit allowed residents for taxes paid to other jurisdictions on their out-of-state income raises no valid constitutional issue with respect to the treatment of nonresidents' New York income.

The cases relied upon by appellants (Jur. St., pp 34-38) do not show any undue burden on interstate commerce here. *Westinghouse Electric Corp. v. Tully*, 466 U.S. 388 (1984), involved a tax credit which discriminated against export

shipping from other states. The tax credit here is neutral with regard to income of nonresidents from sources outside of New York. Residents and nonresidents are taxed in the same way on New York source income. In *Austin v. New Hampshire*, 420 U.S. 656 (1975), the New Hampshire tax was designed to tax income of nonresidents which they earned in New Hampshire but effectively exempted income of New Hampshire residents, thus discriminating against nonresidents. *Halliburton Oil Well Cementing Co. v. Reily*, 373 U.S. 64 (1963), is also distinguishable from the case here. In that case, sales taxes applied to different bases depending upon the jurisdiction in which equipment used in the taxing state was manufactured. The case did not involve discrimination against nonresidents, vis-a-vis, residents and none is involved here.

POINT III

The United States Constitution was not violated by the termination of a letter agreement dissolving a pending tax controversy for years not in issue here.

Finally, the termination of the 1972 letter agreement involves no constitutional deprivation. The letter agreement in issue, dated November 22, 1972, was made by a New York Deputy Tax Commissioner, resolved the personal income tax liabilities of employees and a nonresident partner of the partnership who provided services for the partnership in Washington, D.C. during the years 1967 through 1971. The agreement is merely a waiver of all of the tax liabilities of those individuals to which the agreement referred for the tax years which were then under consideration. Such agreements are not uncommon and have been terminated for future years not covered by the agreements in situations where they did not conform with the New York Tax Law and resulted in an improper amount of taxes being

reported to New York State. *See, Matter of Petrie Stores Corp. v. Tully*, 80 N.Y. A.D.2d 328 (3d Dept 1981). The agreement did not compromise any tax liability and there was no consideration given for it. Thus the agreement was not a contract.

The letter agreement states that it could be changed for future years if New York suffered a loss in tax revenues as a result of it. At the time that the letter agreement was signed, it appeared that nonresident partners in the New York office of the partnership were not allocating their share of partnership income between New York and Washington, D.C. but were reporting their entire partnership distributive share as allocable to New York for State and New York City tax purposes. For later years, nonresident partners in the New York office of the firm allocated their distributive shares of the partnership's income between New York and Washington, D.C. during the years in issue, 1976 through 1979. As a result, New York would have suffered a net revenue loss because of the allocation by the nonresident New York partners if it also continued to permit nonresident partners, such as appellants, not to pay taxes on that part of their distributive share of New York partnership income derived from New York sources. Plainly, New York was entitled to tax 100% the partnership income derived from New York sources.

Moreover, the letter agreement was not authorized by New York Tax Law § 637(d). It provides: "[t]he tax commission may, on application, authorize * * * other methods of determining a non-resident partner's portion of partnership" income derived from New York sources. The appellants do not claim that an application was made by any member of their partnership to the New York Tax Commission for authorization to allocate the source of their partnership income by a method other than that provided by

statute or the regulations of the Tax Commission. There was no evidence that it was approved by the Tax Commission. The letter agreement was not a section 637(d) authorization.

Accordingly, the termination of the agreement was not an impairment of a contract in violation of the United States Constitution nor a violation of any New York law.

Conclusion

Wherefore, appellees respectfully submit that the questions upon which this case depends are so insubstantial as not to need further argument, and appellees respectfully move the Court to dismiss this appeal, or, in the alternative, to affirm the judgment entered in this case by the Court of Appeals of the State of New York.

Dated: Albany, New York
February , 1988

Respectfully submitted,

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APPENDIX.

Statutes and Regulations Involved

RELEVANT PROVISIONS OF THE NEW YORK TAX LAW:

§ 601. Persons subject to tax

* * *

(b) Partners and partnerships. A partnership as such shall not be subject to tax under this article. Persons carrying on business as partners shall be liable for tax under this article only in their separate or individual capacities.

§ 612. New York adjusted gross income of a resident individual

(a) General. The New York adjusted gross income of a resident individual means his federal adjusted gross income as defined in the laws of the United States for the taxable year, with the modifications specified in this section.

§ 620. Credit for income tax of another state

(a) General. A resident shall be allowed a credit against the tax otherwise due under this article for any income tax imposed for the taxable year by another state of the United States, a political subdivision of such state or by the District of Columbia, upon income both derived therefrom and subject to tax under this article.

§ 632. New York adjusted gross income of a nonresident individual

(a) General. The New York adjusted gross income of a nonresident individual shall be the sum of the following:

(1) The net amount of items of income, gain, loss and deduction entering into his federal adjusted gross income, as defined in the laws of the United States for the taxable year, derived from or connected with New York sources, including:

(A) his distributive share of partnership income, gain, loss and deduction, determined under section six hundred thirty-seven * * *

§ 637. Nonresident partners

(a) Portion derived from New York sources.

(1) In determining New York adjusted gross income of a nonresident partner of any partnership, there shall be included only the portion derived from or connected with New York sources of such partner's distributive share of items of partnership income, gain, loss and deduction entering into his federal adjusted gross income, as such portion shall be determined under regulations of the tax commission consistent with the applicable rules of section six hundred thirty-two.

* * *

(b) Special rules as to New York sources. In determining the sources of a nonresident partner's income, no effect shall be given to a provision in the partnership agreement which—

(1) characterizes payments to the partner as being for services or for the use of capital, or

(2) allocates to the partner, as income or gain from sources outside New York, a greater proportion of his distributive share of partnership income or gain than the ra-

tio of partnership income or gain from sources outside New York to partnership income or gain from all sources, except as authorized in subsection (d), or

(3) allocates to the partner a greater proportion of a partnership item of loss or deduction connected with New York sources than his proportionate share, for federal income tax purposes, of partnership loss or deduction generally, except as authorized in subsection (d).

• • •

(d) Alternate methods. The tax commission may, on application, authorize the use of such other methods of determining a nonresident partner's portion of partnership items derived from or connected with New York sources, and the modifications related thereto, as may be appropriate and equitable, on such terms and conditions as it may require.

RELEVANT REGULATIONS OF THE NEW YORK STATE TAX COMMISSION IN EFFECT FOR THE YEARS UNDER REVIEW

Methods of Allocating Income and Deductions From Sources Within and Without New York State

131.13 Apportionment and allocation of income from a business carried on partly within and partly without the State. If a nonresident individual, or a partnership of which a nonresident individual is a member, carries on a business, trade, profession or occupation both within and without the State, the items of income, gain, loss and deduction attributable to such business, trade, profession or occupation must be apportioned and allocated to this State on a fair and equitable basis in accordance with approved methods of accounting.

(a) If the books of the business are so kept as regularly to disclose to the satisfaction of the Tax Commission the proportion of the net amount of the items of income, gain, loss and deduction derived from or connected with New York sources, the return of the taxpayer shall disclose the total amount of such items, the net amount of such items allocated to New York, and the basis upon which such allocation is made.

(b) If the books and records of the business do not disclose to the satisfaction of the Tax Commission the proportion of the net amount of the items of income, gain, loss and deduction attributable to the activities of the business carried on in New York, such proportion shall, except as provided in section 131.14 and subdivision (b) of section 116.7 be determined by multiplying (1) the net amount of the items of income, gain, loss and deduction of the business by (2) the average of the following percentages:

(i) *Property percentage.* (a) General. The percentage computed by dividing (1) the average of the values, at the beginning and end of the taxable year, of real and tangible personal property connected with the business and located within this State by (2) the average of the values, at the beginning and end of the taxable year, of all real and tangible personal property connected with the business and located both within and without this State. For this purpose, real property shall include real property rented to the taxpayer and used in the business. Real property the income or gain from which is allocated pursuant to section 131.14 of these regulations shall be disregarded in computing the property percentage described in this paragaraph.

(b) *Rented real property*. (1) The fair market value of real property, both within and without New York, which is rented to the taxpayer shall be determined by multiplying the gross rents payable during the taxable year by eight.

(2) Gross rents as used in this clause is the actual sum of money or other consideration payable directly or indirectly by the taxpayer or for its benefit for the use or possession of the property and includes:

(i) any amount payable for the use or possession of real property, or any part thereof, whether designated as a fixed sum of money or as a percentage of sales, profits or otherwise;

(ii) any amount payable as additional rent or in lieu of rent, such as interest, taxes, insurance, repairs or any other amount required to be paid by the terms of a lease or other arrangement;

(iii) a proportionate part of the cost of any improvement to real property made by or on behalf of the taxpayer which reverts to the owner or lessor upon termination of a lease or other arrangement, based on the unexpired term of the lease commencing with the date the improvement is completed (or the life of the improvement if its life expectancy is less than the unexpired term of the lease), provided, however, that where a building is erected on leased land by or on behalf of the taxpayer, the value of the land is determined by multiplying the gross rent by eight, and the value of the building is determined in the same manner as if owned by the taxpayer. The proportionate part of the cost of an improvement (other than a building on leased land) is generally

equal to the amount of amortization allowed in computing New York adjusted gross income, whether the lease does or does not contain an option of renewal.

(3) Gross rents do not include:

(i) any portion of a payment or credit to the proprietor of the business or to a partner in the partnership conducting the business for the use of real property;

(ii) amounts payable as separate charges for water and electric service furnished by the lessor;

(iii) amounts payable for storage where no designated space under the control of the taxpayer as a tenant is rented for storage purposes;

(iv) that portion of any rental payment which, in the discretion of the Tax Commission, is applicable to property subleased by the taxpayer and not used by him or it in the carrying on of the business.

(c) If the general method outlined herein results in valuations which are inaccurate or which are not fair and equitable, any other method which will fairly and equitably reflect the value may be adopted by the Tax Commission either on its own motion or on request of a taxpayer. A request by a taxpayer for an alternative method may be made at the time of the filing of the return to which it relates by using the proposed method in the return provided the method is fully explained in the return. Any request should contain all facts with respect to the property forming the basis for the proposed valuation and also a computation of the value of the rented real property based on gross rents in accordance with clause (b) above. Such basis or such other method once approved by the commission may be used

without specific approval for subsequent years until the facts upon which it is based are materially changed.

(ii) *Payroll percentage.* The percentage computed by dividing (a) the total wages, salaries and other personal service compensation paid or incurred during the taxable year to employees in connection with the business carried on within this State, by (b) the total of all wages, salaries and other personal service compensation paid or incurred during the taxable year to employees in connection with the business carried on both within and without this State.

(iii) *Gross income percentage.* The percentage computed by dividing (a) the gross sales or charges for services performed by or through an office, branch or agency of the business located within this State, by (b) the total of all gross sales or charges for services performed within and without this State. The sales or charges to be allocated to this State shall include all sales negotiated or consummated, and charges for services performed, by an employee, agent, agency or independent contractor chiefly situated at, connected by contract or otherwise with, or sent out from, offices, branches of the business, or other agencies, situated within this State.

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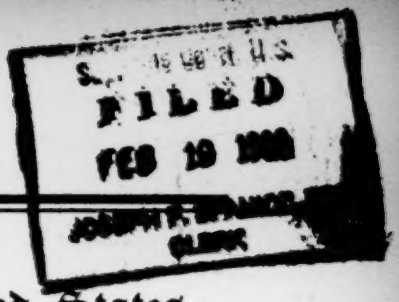

IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

RUSSELL T. WEIL and VIRGINIA L. WEIL,
STUART S. DYE and MARY I. DYE,
ROBERT J. HICKEY and ELEANOR L. HICKEY, and
RUSSELL T. WEIL, RONALD L. CAPONE, and
JILDA C. GARITY, as Executor, Administrator cta,
and Administratrix cta, respectively, of the Estates
of Ronald A. Capone and Margaret L. Capone,
Appellants,

v.

RODERICK G.W. CHU, FRANCIS KOENIG, and
MARK FRIEDLANDER, constituting the
State Tax Commission of the State of New York,
Appellees.

ON APPEAL FROM THE COURT OF APPEALS OF THE STATE OF NEW YORK

APPELLANTS' REPLY TO MOTION TO DISMISS OR AFFIRM

February 19, 1988

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No. 87-1179

IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1987

RUSSELL T. WEIL and
VIRGINIA L. WEIL, STUART S. DYE and
MARY I. DYE, ROBERT J. HICKEY and
ELEANOR L. HICKEY, and RUSSELL T. WEIL,
RONALD L. CAPONE, and JILDA C. GARITY,
as Executor, Administrator cta, and
Administratrix cta, respectively, of the
Estates of Ronald A. Capone and
Margaret L. Capone, Appellants,

v.

RODERICK G.W. CHU, FRANCIS KOENIG,
and MARK FRIEDLANDER, constituting
the State Tax Commission of the State
of New York, Appellees.

ON APPEAL FROM THE COURT OF APPEALS
OF THE STATE OF NEW YORK

APPELLANTS' REPLY TO MOTION TO DISMISS OR AFFIRM

Appellants hereby briefly reply to the "Motion To Dismiss Or Affirm" filed by appellees in this case.

I. Appellees' Contentions Regarding The Source of Appellants' Incomes From Their Legal Practice

Appellees' motion fails to address the real facts of appellants' case or the case law cited in appellants' Jurisdictional Statement ("J.S."). For example, appellees' motion (p. 7) discusses the due process issue in less than one sentence, simply repeating the issue rather than establishing a bona fide New York source. Appellees merely state that taxes on nonresident individuals have been constitutionally upheld where they have "sources" within the state.[1] Appellees in the same sentence similarly conclude, without discussion, that there is no equal protection or privileges and immunities problem,

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[1] Appellees cite Travis v. Yale & Towne Mfg. Co., 252 U.S. 60 (1920). The case is inapposite as to the source issue for numerous reasons, including the fact that it involved taxation of employees of a Connecticut corporation doing business in New York, and there was no substantive dispute about income "source."

citing one inapplicable case for both issues.[2] Moreover, appellees make no mention of the numerous statutory and regulatory provisions cited by appellants for determining "source" (see J.S. 25-26 n.9).[3]

Rather, appellees essentially predicate their entire argument on the contention that appellants must be taxed because their partnership has a New York office, thus admitting that their argument focuses on

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[2] American Commuters Assoc. v. Levitt, 405 F.2d 1148 (2d Cir. 1969). The case did not involve a partnership situation, the nonresident taxpayers were employees of a New Jersey corporation who actually commuted and worked in New York, and the plaintiffs in that case admitted that they received both earned income and substantial benefits from doing business in New York.

[3] For example, the IRS regulation codified at 26 C.F.R. §301.6362-5(d)(1) requires that personal service income "shall be considered to have been derived from sources within a state only if the services of the taxpayers, which gave rise to the income, are performed in such state." See also Craik v. United States, 31 F.Supp. 132 (Ct. Cl. 1940); Tax Review Board v. D.H. Shapiro Co., 185 A.2d 529 (Pa. 1962).

the income of the partnership, not that of the nonresident individuals. Appellees' motion (p. 7) asserts that "the activity taxed here has a substantial nexus to New York" solely because appellees focus only on the "activity" of the partnership, rather than individual appellants' legal practice, which produces their incomes.[4] Appellees' erroneous focus leads them to incorrectly state that appellants "performed services for [their] partnership" (motion, p. 2), when, in fact, they

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[4] Appellees cite Complete Auto Transit v. Brady, 430 U.S. 274 (1977), and Shaffer v. Carter, 252 U.S. 37 (1920), regarding the interstate commerce issue. Appellees conclude that the requirements of Complete Auto Transit are met in this case only because they cite the activities of appellants' New York partners rather than appellants' legal practice in Washington. As to the Shaffer decision, that case concerned an individual nonresident who engaged in business in Oklahoma: he purchased, developed and operated land leases in Oklahoma, which assessed an income tax thereon. The case had nothing whatever to do with a partnership arrangement, a distributive share tax assessment, or any of the other relevant issues.

clearly performed services for their clients in Washington, D.C. (J.S. 8-10). Similarly, appellees erroneously place emphasis on the partnership's "bookkeeping department" in New York (motion, p. 3), while ignoring the fact that all of appellants' records relating to client services and billing were kept in Washington (J.S. 9-10, 18a-19a).

Clearly, the factor for determining the "source" of a partner's income is where the individual performs his services, not the location of the partnership's offices. The tax assessment involved in this case is against the individual appellants, not their firm. Indeed, under New York law, a partnership is not a taxable entity, Williams v. Hartshorn, 296 N.Y. 49 (1946), and Section 601(b) of the New York Tax Law specifically provides that:

> A partnership as such shall not be subject to tax.... Persons carrying on business as partners shall be

> liable for tax...only in their separate or individual capacities. [Emphasis added].

In attempting to support their legal position, appellees also contend that all appellants' incomes belong initially to the partnership, with no separate property right in the income until distribution, that a partner's interest is his share of the profits and surplus, and that under appellants' partnership agreement gross fees earned by the partners were fees of the firm (motion, p. 7-8). Again, appellees are misfocusing the issue on a non-taxable entity, the partnership, instead of the individual partners and the place where the services giving rise to the taxable income are performed. The individual rights a partner may or may not have as to specific assets of the firm or what the distributive share may be for each partner is irrelevant to the source argument. The question is the "source" of

the income appellants received and whether that source is New York. Moreover, the record does not support any assertion that all money earned by appellants belonged to the partnership as a whole, or that each partner's interest equaled his share of the profits and surplus. In fact, appellants retained earnings from their legal services to pay their expenses, and partnership shares were used only as a starting point to determine distribution (J.S. 10, 25 n.9).

Finally, appellees contend (motion, p. 8) that payment of appellants' distributive share depended on the profitability of the partnership as a whole, and that if the partnership suffered a loss, or if the New York office generated less profits, appellants' distributive shares would have been less. No citation to the record is given for these unsupported theories. Indeed, no correlation existed between the

money received by the firm and appellants' distributive shares (J.S. 10, 25 n.9). Appellants' Washington office subsidized the New York office such that the New York partners' income-producing activities could have dropped with no affect on the amount distributed to appellants (Id.).

II. Appellees' Contentions Regarding Their Denial Of Tax Credits To Appellants

Appellees' motion insists that New York State may constitutionally deny non-residents the credit provided to New York residents for taxes paid to other states and political subdivisions. However, none of the cases cited in appellees' motion (pp. 9-11) upholds disparate treatment of residents and nonresidents in regard to tax credits. Indeed, the cited cases support appellants' position since they condemn

disparate treatment based on nonresidency alone.[5]

Appellees urge that the credit is merely designed to avoid "double taxation of income," which they erroneously assume to be a problem that affects only New York residents (motion, p. 10). In fact, double taxation is a problem that appellants indisputably face as a result of appellees' efforts to tax their income (J.S. 27 n.10), and it is unconstitutional to afford residents relief from double taxation while denying appellants relief from the very same problem. Williams v. Vermont, 472 U.S. 14, 27 (1985).

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[5] Appellees' motion either ignores the cases cited in appellants' Jurisdictional Statement, e.g., Austin v. New Hampshire, 420 U.S. 656 (1975); Travis v. Yale and Towne Mfg. Co., 252 U.S. 60 (1920); Williams v. Vermont, 472 U.S. 14 (1985); Westinghouse Electric Corp. v. Tully, 466 U.S. 388 (1984), or refers to factual variations in those cases that do not change the legal conclusion that appellees' actions are unconstitutional.

Appellees' assertion (motion, pp. 9-11) that there is, in fact, no disparate treatment of residents versus nonresidents is patently false: whenever a resident and nonresident have the same New York taxable income, subject to both New York and out-of-state taxes, under appellees' scenario the nonresident must pay higher taxes to New York than the resident as a result of the credit granted only to residents.[6] This is so despite the fact that nonresidents receive their basic governmental

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[6] In appellees' example (motion, p. 10 n.3), nonresident "C" pays taxes on 100 percent of his New York taxable income, while resident "B" pays taxes on only 75 percent of his New York taxable income. Therefore, through the tax credit New York subsidizes its residents by paying out-of-state taxes for them, but grants no subsidy to nonresidents, who are subjected to double taxation. This unreasonable discrimination is unconstitutional, notwithstanding appellees' citation (p. 11) of the Toomer, Goodwin, and Travelers' Insurance cases, which were based on entirely different factual circumstances that required a different result.

services elsewhere.[7]

III. Appellees' Contentions Regarding Their §637(d) Agreement With Appellants

Appellees' motion largely ignores the 1972 agreement between the State Tax Commission and appellants. However, this matter cannot be swept aside so easily.

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[7] Appellees also assert that discriminatory treatment of nonresidents is cured because nonresidents are taxed only on their New York source income (motion, p. 11). However, in Aurora Corp. v. Tully, 60 N.Y.2d 338, 345 (1983), the New York Court of Appeals expressly held that disparate treatment of residents and nonresidents cannot be justified on the basis that a resident's entire income is taxed by New York while a nonresident is taxed only on income connected to New York. The law review article cited elsewhere in appellees' motion also rejects appellees' position: "the denial of a credit to nonresidents virtually guarantees that they will be denied a credit for taxes paid to their state of residence but levied in part upon income earned in the state of nonresidence. It therefore cannot be suggested that such denial relates only to taxes that are not 'connected' with income arising from sources in the taxing state." Hellerstein, "Some Reflections On The State Taxation Of A Nonresident's Personal Income," 72 Mich. L. Rev. 1309, 1352-53 (1974).

Appellees have long conceded that Deputy Tax Commissioner Donovan entered into an "agreement" with appellants,[8] and they have similarly conceded that appellants have consistently observed and relied on that agreement to their detriment (see J.S. 10-14, 39-42). Yet, appellees' motion (p. 13) now maintains that "appellants do not claim that an application was made by any member of their partnership" for an agreement pursuant to §637(d) of the New York Tax

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[8] While referring to their "letter agreement," appellees' motion inconsistently states (p. 14) that there was "no evidence that it was approved by the Tax Commission." However, the record is clear that Mr. Donovan made an institutional decision. Also, appellees have never asserted, and do not assert now, that the agreement was not approved by the Commission. Further, appellees fail to note that appellants were prevented by the Tax Commission, with court approval, from engaging in discovery as to the Commission's records. In these circumstances, where the records were within appellees' control, appellees cannot belatedly contend, consistent with due process, that appellants failed to produce appropriate "evidence."

Law. This assertion is absolutely false. Indeed, the Tax Department's Exhibit 93 in this case expressly states that appellants formally met with officials of the Department and requested that their tax reporting method "be accepted as an alternate method of allocation as provided under the Statute [§637(d)]." So too, appellants' method was approved on November 22, 1972 by Mr. Donovan on the official stationery of the Tax Department and the State Tax Commission.

Appellees' motion (p. 13) also contends that Mr. Donovan's §637(d) agreement is invalid because there allegedly would be a loss of revenue to the state because one or two of appellants' New York partners, nonresidents of New York, reportedly allocated their income between the two offices of appellants' firm. However, appellees earlier concluded as a matter of law that any loss of income to the state

was "irrelevant" (J.S. 26a). Furthermore, appellees' new theory is totally inaccurate since the substantial profits flowing from appellants' Washington office to the New York-based partners surpassed any loss now alleged by appellees, profits that were taxed by the state (J.S. 13-14 n.3).

Finally, appellees' motion (pp. 12-13) asserts that neither due process nor contractual rights require New York to adhere to its agreement because there was "no consideration" for the agreement. This too is patently false. Appellees previously conceded that appellants consistently observed the agreement and acted in reliance on the agreement to their detriment (see J.S. 23a-24a). This clearly constitutes consideration, and appellees are thus required to abide by their

agreement as a matter of law (see J.S. 39-44).[9]

IV. Conclusion

For all the foregoing reasons, and those cited in the Jurisdictional Statement, appellants respectfully submit that this case presents substantial constitutional questions warranting this Court's plenary review. If appellees' position is allowed to stand, professionals throughout the country will be subjected to multiple taxation even though they do not practice in the taxing states. Thus, appellees' Motion To Dismiss Or Affirm should be denied.

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[9] Futhermore, as a matter of equity appellees' agreement, combined with appellants' detrimental reliance on that agreement, estops appellees from now denying the validity of their agreement. See, e.g., the following tax estoppel cases: Miller v. United States, 500 F.2d 1007 (2d Cir. 1974); Simmons v. United States, 308 F.2d 938 (5th Cir. 1962); Shuster v. Commissioner, 312 F.2d 311 (9th Cir. 1962).

Respectfully submitted,

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